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Madame Chairwoman, Madame Ranking Member, and distinguished members of the subcommittee, it is an honor to be here today to discuss with you the recently announced changes to the Home Affordable Modification Program as well as the program's successes and failures to date. My name is Andrew Jakabovics, and I am the Associate Director for Housing and Economics at the Center for American Progress Action Fund. Since testifying before this committee last March about expectations for HAMP, I have been analyzing the program and providing recommendations for improvement. I have directly engaged with Treasury and other administration officials about the program and have written extensively about it. Today, I will share my analysis of recent program changes and recommendations for further action.

Through the end of February, approximately 1.1 million homeowners have been offered trial modifications under HAMP, but only 170,000 have successfully negotiated the seemingly Byzantine process for getting into a permanent modification. While there remain significant operational barriers to HAMP's full-fledged success, the administration's new initiatives are likely to bring relief to a subset of homeowners struggling to pay their mortgages.

New policies to help underwater borrowers

The most potentially wide-ranging new policies are those designed to address the problem of "negative equity" (homeowners owing more than their homes are worth) by bringing the amount owned on mortgages down to the current value of the properties. HAMP has been criticized by its overseers for essentially trying to address last year's bad mortgages—subprime and other exotic loans whose terms were largely unsustainable from the start. In moving to offer underwater but otherwise creditworthy borrowers an FHA refinancing and in bringing principal writedowns into the HAMP modification process, the administration is attempting to tailor its response to address the current problem of prime loans going bad.

As of the end of last year, 30.6 percent of subprime loans were at least 90 days past due or in foreclosure. By comparison, only 7 percent of prime loans were in the same category.[1] However, when looking at absolute numbers, it is clear that addressing the

problems faced by borrowers with prime mortgages is critical: The Mortgage Bankers Association survey covers 33.5 million prime loans outstanding, compared to fewer than 4.6 million subprime mortgages. In other words, there are nearly a million more prime loans that are seriously delinquent or in foreclosure than subprime loans.

When borrowers face job losses, illness, death, or divorce, delinquency often results. But as long as borrowers have some equity in their home or are not too far underwater, they will often do everything in their power to keep their homes. When these common default factors are coupled with significant negative equity, however, the decision to simply walk away from the home (and its mortgage) becomes much easier.

The decision to walk away, leaving the home vacant and abandoned, harms the value of neighboring properties, hurting people who may still be struggling to keep up with their own mortgages. That's a major problem for communities across the country when an estimated 24 percent of all houses with mortgages are worth less than the remaining balance on those mortgages.[2] Writing down the amount of outstanding mortgages to bring them in line with the current values of the properties provides an opportunity to create the conditions for homeowners to keep paying their mortgages over the long term and minimize the walkaway risk that threatens their neighbors' financial health.

FHA refinancing for underwater borrowers

Since the housing crisis began, CAP has argued that the best solution is to restructure mortgages to reflect current property values.[3] Drawing on the experience of history, the new initiative announced by the Obama administration involving the Federal Housing Authority and the $700 billion Troubled Asset Relief Program fits the bill. Indeed, the new program is essentially a modern version of the New Deal's Home Owners' Loan Corporation, which helped homeowners in the 1930s weather the Great Depression.[4]

Under the Obama administration's program, borrowers who are current on their loans but owe more on their homes than they are currently worth can refinance into an FHA loan for 97.75 percent of the property's current value, assuming the borrowers meet all other FHA underwriting criteria. Incentives will be paid to the mortgage service companies handling the flow of mortgage principal and interest payments to lenders and investors in these mortgages so that borrowers can refinance for less than the outstanding amount.

Given the much larger losses lenders and investors would face if borrowers defaulted, cash in hand equal to 97.75 percent of current value may be sufficiently attractive to allow these refinancings to proceed. This is actually a somewhat sweeter deal for lenders and investors than was offered by FDR's administration by the Home Owners Loan Corporation; back then, the new mortgage was for only 80 percent of current value and the lenders were given corporate bonds paying 4 percent in the amount of the new HOLC loan, not a cash buyout.

Moreover, the new FHA refinance program will allow a total indebtedness of 115 percent of the home's current value, so existing lenders and investors will still be able to retain

almost a fifth of the property's current value as a junior lien on the property, effectively giving them some ongoing cash flow if the loan performs and some upside if property values rise before foreclosure. In cases where there is an existing second lien on the home (in the form mostly of a home equity loan) then the first- and second-lien holders would need to negotiate how to divide losses down to the 115 percent loan-to-value limit.

About half of all homes have second liens on the property. Given the difficulties faced by the administration's first effort to help responsible homeowners refinance their mortgages through its Making Home Affordable program because of second liens, this program will be most useful for borrowers with only a first mortgage. (See below for more on the second-lien program.)

To finance this new program, $14 billion from the Troubled Asset Relief Program will be set aside. Even though these refinancings will be FHA loans in all respects and must qualify on those terms, TARP will be on the hook for future claims in a first-loss position. The new program also will bolster FHA's insurance fund, whose excess reserves are below their statutory minimum, since premiums will be paid into the fund but claims will first be drawn down from TARP.

Principal reductions within HAMP

For HAMP-eligible borrowers—meaning those borrowers already determined to be eligible for mortgage refinancings—the Net Present Value test will now be run a second time to calculate the value of a modification that includes a principal writedown. Under the existing HAMP NPV test, the monthly payment target of 31 percent of a borrower's income is reached by reducing the interest rate to as low as 2 percent, extending the length of the loan to as much as 40 years, or forbearing part of the loan so that no interest is due on that amount.

To qualify for the new program, the results of the two NPV tests will be compared so that mortgage service companies will see the logic of participating in the program. The mortgage service companies will be under no programmatic obligation within HAMP to modify mortgages using a principal writedown even when the NPV results show it to be more valuable, yet servicers' existing legal obligations to lenders and investors to get the best possible returns from modifications would make it difficult for servicers to choose the standard HAMP modification when the principal writedown alternative yields better returns under the same NPV model.

Furthermore, in most instances, principal writedowns will probably be more valuable compared to the current HAMP modifications, because of the reduced redefault risk from a lower loan-to-value ratio. The propensity for borrowers to walk away from severely underwater loans improves the NPV calculation for principal balance writedowns compared to interest-rate adjustments for the same targeted monthly payment. Moreover, the program incentivizes borrowers to remain current because the amount forgiven will be deducted from the loan balance over the course of the next three years, as long as the borrower remains current on their loan.

Despite the strong rationales for shifting towards principal reductions, however, there is no transparency for investors to determine that servicers are choosing to reduce principal when that option is more valuable. Thus, while running an apples-to-apples comparison of the NPV results from the standard HAMP waterfall and the principal reduction case should result in the servicer choosing the more valuable outcome, writedowns remain voluntary and there is no mechanism to force them to happen.

Similarly, this policy's ultimate success will likely be determined by the success of the administration's so-called 2MP program, which is designed to buy out second-lien holders for pennies on the dollar but has yet to get off the ground. The four largest banks, which collectively hold about 80 percent of all second liens, are also the four largest mortgage servicers. Only very recently did all four agree to participate in the 2MP program. And under the new administration program to encourage the elimination of second liens prior to the principal writedowns, which will necessarily generate losses for first-lien holders, the incentive payments to the second-lien holders under 2MP will be doubled. If 2MP proves ineffective at eliminating second liens, however, it is unlikely that first liens will be written down.

But there is reason for optimism. Commercial banks that still hold the mortgages they originated are now beginning to offer principal reductions for loans they originated and hold in their portfolios, recognizing the value in reducing the risk of redefault. Indeed, nearly all principal reductions reported in the most recent Mortgage Metrics Report were done for loans held in servicers' own portfolios.[5] More than a quarter of all portfolio loans modified in the fourth quarter of last year involved some degree of principal reduction. Assuming that the distribution of modifications to date reflect the broader pool of HAMP-eligible mortgages, however, fewer than 10 percent of eligible loans are held in portfolio.[6]

Recently, Bank of America announced its own program of principal reductions for borrowers with certain exotic mortgages.[7] Bank of America's new program is expected to reach only 45,000 borrowers, but the rationale behind principal reductions should argue for the program's rapid expansion to all 1 million-plus estimated HAMP eligible mortgages in their servicing portfolio.

To date, neither Fannie Mae nor Freddie Mac has issued guidance to their servicers indicating that they are going to participate in principal reductions when the NPV test shows them to be more valuable. Nearly 60 percent of all modifications to date have been made for GSE loans. If FHFA in its role as conservator of the GSEs directed them to participate, HAMP would look very different, as principal reductions would likely become the norm. Furthermore, adopting a preference for principal reduction would ultimately benefit the Enterprises' bottom lines and, by extension, the taxpayers.

Treasury must quickly issue a supplemental directive telling servicers exactly how to implement principal reductions within the HAMP waterfall and how to treat the forgiven amount during the three-year writedown period. This should be done immediately and irrespective of forthcoming changes to the NPV model.

Assistance for unemployed borrowers

As indicated above, one of the major causes of delinquency is job loss or diminished wages. While HAMP does allow unemployment benefits to be counted for the NPV test, in many cases, by the time borrowers fall behind on the mortgage and apply for assistance, there is not enough time left on the benefits to allow them to be included in the income calculation. Treasury recently announced a forbearance program that would give unemployed borrowers three, and possibly six, months of forbearance before being considered for a HAMP modification. While this will be of use to some borrowers, the average worker is taking 20 weeks, or about five months, to find a new job, and a record-breaking 44.1 percent of unemployed workers have been actively looking for a new job for more than six months.[8] Thus, the announced assistance for unemployed homeowners is unlikely to help many affected borrowers.

It has been argued that forbearance periods longer than six months may have accounting implications for lenders and investors, who might be forced to write down the value of those loans, but if Treasury provided TARP funds to pay part of the forborne amount, those writedowns might be avoidable. One option would be for the homeowner to be responsible for principal payments during the period of unemployment, with TARP covering part of the interest payment. Investors would forgo the remaining interest.

Outstanding issues

The biggest barrier to program success has been the ability of servicers to quickly and accurately modify loans. Unfortunately, as HAMP has been implemented, Treasury has largely relied on large carrots to get servicer participation and has generally, if not entirely, eschewed sticks. The Servicer Participation Agreement contains no real penalties for noncompliance, save withholding incentive payments. But since those payments are only generated from modifications, when servicers fail to modify loans, there are few payments to withhold. Borrowers and their advocates frequently find servicers are making mistakes on a range of program elements but there is no consistent, independent mechanism for redress, despite calls for developing a robust appeal process since the program's beginning. (We have argued that mandatory mediation prior to foreclosure can provide an appeal for a wrongful HAMP denial as well as an opportunity to negotiate a short sale or deed-in-lieu-of-foreclosure.[9])

I testified before this committee a little over a year ago and argued that if servicers proved unable to meet the reasonable levels of modification activity expected, the time will have come to move from carrots to sticks.[10] Treasury must consider transferring servicing rights from servicers unable to meet their obligations to Treasury under the participation agreements to those who have demonstrated capacity to get it right. While borrowers wrongfully denied assistance under HAMP have been given no standing to sue for servicer noncompliance, servicers' breach of contract should be met with a Treasury lawsuit seeking specific performance. Remedies could include the appointment of a special master and/or transfer of servicing rights.

Another issue that has plagued the program from the beginning is the lack of transparency across a range of program elements. The NPV test that lies at the heart of HAMP analysis has never been publicly released, limiting the possibility of an open dialog or debate about the model. Keeping the NPV model out of the public's eye also means that borrowers do not know on what criteria they are being evaluated or whether the reasons given for denials are valid. For example, FICO scores are used in the NPV test, but borrowers are not told to make sure their credit reports are accurate before applying for HAMP. Similarly, Social Security income should be "grossed up" before being run through the model, but there is no way for a borrower to verify that that was done.

When MHA Compliance officers find systemic problems with HAMP compliance at a servicer, they immediately send a letter halting all foreclosures by that servicer until the problems are rectified. (These letters now conform with recent guidance clarifying that referrals to foreclosure must also cease, not just foreclosure sales.) However, the lack of transparency around compliance violations means that borrowers are never notified not only that they may be reconsidered for HAMP but that the letter saying their home will be put up for foreclosure sale is now null.

Improving HAMP with a web portal

One consistent shortcoming of the HAMP program has been the lengthy delay between announced improvements and implementation. Unfortunately, Treasury has essentially outsourced implementation and oversight of the program to the individual services and the GSEs. For example, much borrower confusion stems from the fact that until recently, there were no standardized HAMP documents, so every borrower had a seemingly different set of requirements to qualify. Even now, servicers are obligated to accept the official HAMP documents but can continue to use their own as well.

Changes to the program and overall throughput and compliance would be much easier if Treasury developed and maintained a single point of contact for borrowers and participating servicers. Specifically, they should develop a HAMP portal where borrowers and their advocates could securely submit applications for modification. Servicers would securely access applications for loans they control and be able to quickly provide borrowers with a response. There are relatively few variables that servicers can change (to date, none has requested permission to use an alternate default model), so even the NPV tests can be run on a central platform once borrowers and servicers have submitted their respective information.

A central, Treasury-controlled platform would allow for quick rollouts of updates to the NPV model (as of now, servicers who do not send their data to Fannie Mae for evaluation must write new computer code and then have it approved by MHA Compliance before putting it in place). More importantly, it would eliminate the "he said, she said" nature of many disputes between borrowers and servicers. Despite copious evidence from borrowers and housing counselors that servicers frequently lose or misdirect applications and other submissions, there is still no process to challenge a servicer who claims never

to have received a document or that an application was incomplete.[11] With a Treasury-controlled portal, every document and activity would be date stamped, thereby eliminating any ambiguity. This also allows for real-time monitoring of servicers' compliance with new obligations for timely responses to borrower requests and allow for simplified escalation and compliance checking.

A portal would also allow the conversion of modifications from the trial to permanent to be simplified. Currently, the trial modification is legally treated only as a forbearance rather than as a true modification. Optimally, the trial modification would be a real modification but the loan terms would reset to the pre-HAMP ones in cases of default in the first three months. With receipt of the third monthly payment under the trial period, the modification would automatically become permanent. The portal would make it easier to track dates and borrower status. The servicer would need to provide proof of delinquency before rejecting a conversion to a permanent modification.

Several HAMP portals have already been developed and implemented with some degree of scale, but Treasury should competitively source an official portal. All HAMP servicers would then simply be required to accept documents submitted through the Treasury-controlled portal. Servicers could still accept and process applications directly, but they would likely find it easier to upload those applications to the portal for processing as well.

Conclusion

In short, the new changes to HAMP and the new role for FHA in addressing the needs of underwater borrowers are necessary and beneficial improvements to public policy that have significant potential to address the current housing crisis. However, without significant process improvements, HAMP is at risk of failing to assist many eligible families. And while the failures may be the servicers', the frustration felt by many may have political implications.

Endnotes

[1] Mortgage Bankers Association, "National Delinquency Survey from the Mortgage Bankers Association, Q409" (2010).
[2] Calculated Risk, "Q4 Report: 11.3 Million U.S. Properties with Negative Equity," available at http://www.calculatedriskblog.com/2010/02/q4-report-113-million-us-properties.html.
[3] Andrew Jakabovics, "Throwing Homeowners a Lifeline" (Washington: Center for American Progress, 2007), available at http://www.americanprogress.org/issues/2007/12/pdf/holc_paper.pdf.
[4] Andrew Jakabovics, "History Lesson," *The New Republic*, September 10, 2007, available at http://www.tnr.com/article/history-lesson.
[5] Office of the Comptroller of the Currency and Office of Thrift Supervision, "OCC and OTS Mortgage Metrics Report, Fourth Quarter 2009" (U.S. Department of the Treasury, 2010), p. 27, available at http://www.ots.treas.gov/_files/482126.pdf.
[6] The actual share of total outstanding mortgages held in portfolio is closer to 15 percent, but that would include jumbo mortgages and other mortgages not eligible for HAMP. See James B. Lockhart III, "Subsidizing the Mortgage Market" (Federal Housing Finance Agency, 2009), available at http://www.fhfa.gov/webfiles/2309/FINAL_for_web-Urban_Land_Institute-05-07-09.pdf.
[7] CNBC, "BofA to Start Reducing Mortgage Principal," March 24, 2010, available at http://www.cnbc.com/id/36012522.
[8] Heather Boushey, "Good News Amid Fragile Recovery" (Washington: Center for American Progress, 2010), available at http://www.americanprogress.org/issues/2010/04/fragile_recovery.html.
[9] Andrew Jakabovics and Alon Cohen, "It's Time We Talked: Mandatory Mediation in the Foreclosure Process" (Washington: Center for American Progress, 2009), available at http://www.americanprogress.org/issues/2009/06/pdf/foreclosure_mediation.pdf.
[10] Andrew Jakabovics, "Examining the Making Home Affordable Program," Testimony before the House Financial Services Committee Subcommittee on Housing and Community Opportunity, March 19, 2009, available at http://www.americanprogressaction.org/issues/2009/03/jakabovics_testimony.html.
[11] Apparently, servicers are already pushing back against participating in HOPE Now's pilot portal specifically because they don't want the accountability of timely responses that come from a process that time and date stamps all activities or losing the ability to claim incomplete submissions.