Why President Obama's Plan Will Not Work and What Will
Testimony of John D. Geanakoplos[1]

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The Two Critical Flaws in the President's Plan

The administration's plan to decrease the number of foreclosures will not work for two reasons.

First, it relies on interest reduction when what is needed, for non-prime borrowers whose homes are underwater, is principal reduction. So far 70% of all foreclosures have been from these non-prime borrowers.

Second, it wastes money by paying servicers to modify loans when servicers have perverse incentives that will remain or grow much worse under the administration's plan—incentives that will lead them to modify in a manner that will not help homeowners and will harm bondholders.

Instead of helping homeowners, the administration plan as currently constructed will enrich the servicers by tens of billions of dollars and further diminish the value of the so-called toxic assets, which are at the heart of the financial crisis that is harming the economy as a whole and costing the taxpayer billions of dollars in support for the banks and other financial institutions.

I provide a brief summary of these two critical flaws in the President's plan and then I go through each problem and provide more detail.

The Misguided Focus on Interest Reduction instead of Principal Reduction

The plan relies on interest reduction to stop the avalanche of foreclosures, but all available data shows that principal reduction is critical to stanching the enormous number of defaults yet to come. Interest reduction has been tried and has produced extremely high redefault rates. Moreover, there is a reason it does not work. For the 1 in 5 homeowners predicted in the next few years to have mortgages greater than the value of their homes, paying even reduced interest rates on a home they do not own and cannot sell, is imprudent, particularly in these hard economic times. They can save money by walking away from their negative equity and renting. For all those with non-prime loans, whose credit rating we can

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[1] James Tobin, Professor of Economics, Yale University. I am also a partner in Ellington Management, LLC, a hedge fund that trades in mortgage backed securities. The views I express herein are neither those of Yale nor those of Ellington, but my own views. I note for the record that I had only two days notice to prepare this document, and many other obligations. The Committee invited me to appear last week but I was not able to confirm my appearance until two days before this hearing because my appearance required me to give notice to the University of Chicago that I would not be able to fulfill a prior obligation to present a paper there on the date the Subcommittee needed me to appear. As a consequence, I have not had enough time to proofread this document with my normal care. I apologize in advance for any typos, grammatical or other errors that I might have missed due to the pressures of time. I thank Professor Susan P. Koniak of Boston University Law School for her assistance in the preparation of this testimony.

safely assume was already impaired, there is little consequence to walking away from their underwater homes and having more money available to meet other pressing family needs.

There is an irony to all the talk about the need to make homeowners more financially literate. The more financially sophisticated a homeowner is, the more likely she is to realize that it makes little economic sense, given an already impaired credit rating, to throw good money after bad by paying reduced interest on an extended mortgage on a home that is underwater.

Servicers Will Continue to Perform Miserably: Paying them is a Waste of Money and Immunizing Them Leaves Them Even Freer than Now to Serve their Own Interests at the Expense of Both Homeowners and Bondholders

Servicers have interests that are not aligned with homeowners or bondholders. Moreover, paying them, as the Obama plan provides, will not correct this misalignment of interests. Making matters worse, immunizing servicers will just leave them freer to serve their own interests at the expense of both homeowners and bondholders.

Absent the threat of suit by bondholders, servicers would be delighted to reduce interest rates to 1% on every loan, or even to 0%. Servicers get their fees from bondholders, not from interest rates. As long as a loan is being paid according to its terms (new or old – low interest rate or high) and not defaulting, the bondholders must continue to pay fees to the servicers. An underwater homeowner facing very low interest payments is still likely to default, but later, so reducing interest rates gets the servicers more fees. Paying servicers to lower interest rates thus wastes money and postpones defaulting, but will not stop it.

When servicers temporarily reduce interest rates to serve their own interests and without reducing principal, the bondholders take the hit on the value of their bonds. Moreover that "hit" leads to no good end because temporarily reducing interest will not stop underwater homeowners from eventually redefaulting. So, servicers benefit without helping homeowners, or bondholders. And when bondholders suffer the American taxpayer now suffers**--**through the various interventions by the Treasury and Federal Reserve, the taxpayer is now effectively guaranteeing the value of many of those bonds in the form of the now infamous toxic assets.

Servicers have a further incentive to reduce interest. Today the biggest volume servicers have been acquired by the big banks. These banks own the lion's share of the second mortgages. By reducing interest on the first mortgages, to induce the homeowners to stay a little longer in their houses, but not changing the second mortgages, the big beneficiaries are the second mortgages, who receive their interest in full. Once again the bondholders lose, the homeowners are not helped in the long run, and the servicers (or the big banks that now owner the major servicers) reap billions of dollars.

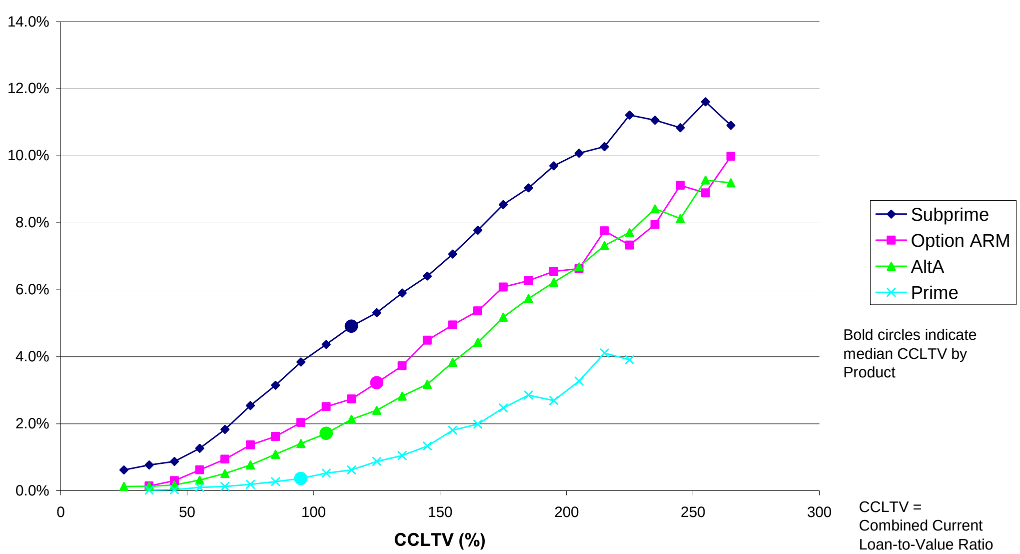
In addition, servicers have neither the staff nor resources to do modifications right; because reducing interest rates is a virtually costless gain to them, they will bank the money we pay them and not reinvest it in hiring people to do modifications right. (As we said, even with the right personnel they would not be the right agents to accomplish effective modifications—the terrible experience most homeowners have had with the servicers to date has caused most homeowners to be quite distrustful of current servicers.) The conflicts between servicers and both homeowners and bondholders are so severe and complex that no amount of tinkering with carrots and sticks will cure the problem. That is why our plan calls for replacing servicers with community banks, government hired trustees, to make the decision to modify or foreclose. [See particularly Geanakoplos and Koniak, NY Times Editorial 10/30/08 and Blind Trustee Outline for Legislation, both provided with this testimony.]

I now turn to elaborating the two major flaws I summarized above

I. Obama's Plan Concentrates on Interest Reduction and Without Principal Reduction Modifications will Fail

- o Principal Reduction is Critical to Prevent Avalanche of Foreclosures, Particularly in Non-Prime Loans that is Still Ahead of Us
    - ▪ According to Congressional Oversight Panel's 3/6/09 report to Congress
        - Over next several years 1 in 5 homeowners will have mortgages higher than the value of their homes
    - ▪ The default rates for all non-prime loans are stunningly sensitive to whether and how much equity a homeowner has.

Monthly Net Flow (Excluding Modifications)
from <60 Days to ≥60 Days Delinquent
Based on Performance from Nov 08 - Jan 09 for all Deals Issued in 2006



- ▪ Explanation of Chart: It shows the remarkably high rate of default for underwater (CLTV > 100) per MONTH. At CLTV = 160%, every month another 8% default, while at 50% CLTV less than 1% default.

- The above chart is a product of a study done by Ellington Management, LLC.

- How CLTV (Current Loan to Value) was calculated

  - Ellington began with original LTV (loan to value) using original sale appraisals, house by house, for the whole universe of toxic mortgages. For that universe of mortgages, loan level data is typically available. It then added up **all** mortgage loans (1st lien and 2nd lien etc..) to get combined loan total. Next, it updated value of homes by taking the Case-Shiller zip code housing index and updated house values zip code by zip code to get current combined LTV (CLTV in graph above).

- How net default rates were calculated

  - Ellington looked at **monthly** net default rates through January 2009. By "net" we mean any loans once delinquent but that became current during that month were subtracted from the total number of delinquencies and modified loans were not included. So, for example, if in a single month 3% of the current pool becomes >= 60 days delinquent and 0% go from over to under 60 days delinquent, Note that, in that example, the monthly rate of 3%, ignores the, say 1% of loans that may have received modifications. Why? Because people get fooled into thinking the housing problem is getting fixed because current delinquent population is held down by modifications (see quote below from Contgressional Oversight Panel on redefaults under modification plans tried in the past—none of which has concentrated on principal reduction).

  - "For example, the Office of Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) have been jointly gathering data on redefault rates on modified loans in the servicing portfolios of fourteen national banks and federal thrifts. This data shows a high rate of redefaults on modified loans. From this the Director of OTS concluded that modification efforts cannot work. The Comptroller, however, noted that the data shows nothing more than the fact that modifications have not worked; without knowing more about the modifications themselves, we cannot conclude that modifications *cannot* work. Cheyenne Hopkins, *When Mods Fail, What Next?:*

Regulators Split on Implications of Redefaults, American Banker, at 1 (Dec. 9, 2008)" Congressional Oversight Panel, 3/6/09 report, footnote 36, at p. 18.

- The graph above (which covers all loans originated in the 2006) shows that across all mortgage types the default rate is extremely sensitivity to CLTV.

- For example, for subprime (ABX) loans, when CLTV <.60, only 1% default per month. When CLTV >1.60, 9% default per month. And the sensitivity to CLTV is dramatic for every type of loan.

- There are sound economic reasons why the default rate so closely tracks negative equity, particularly for non-prime borrowers.

  - Think of a couple with a combined income of $75,000. They took out a subprime mortgage for $280,000, but their house has depreciated to a value today of $200,000. They've been paying their mortgage each month, about $25,000 a year at a 9 percent rate including principal and interest. But the interest rate is not the problem. The real problem is that the couple no longer "own" this house in any meaningful sense of the word.

  - Selling it isn't an option; that would just leave them $80,000 in the hole. After taxes, $80,000 is one and a half years of this couple's income. And if they sacrifice one-and-a-half years of their working lives, they will still not get a penny when they sell their home.

  - This couple could rent a comparable home for $10,000 a year, less than half of their current mortgage payments — a sensible cushion to seek in these hard times. Yes, walking away from their home will further weaken their credit rating and disrupt their lives, but pouring good money after bad on a home they do not really own is costlier still.

  - President Obama's plan does nothing to change the basic economic calculation this hard-pressed family and millions of others like it must make. The Obama strategy — which involves reducing their interest rate for five years and giving them, at most, $5,000 for principal reduction over five years — will still leave them paying much more than the $10,000 it would cost them to rent.

Comment [tharshaw1]: √

- Given the hard data from all sources (see below for description of other data, which is all consistent with the chart provided above) and the economic rationale for the behavior revealed by the data, it is preposterous to contend that defaults are primarily a function of job loss or a worsening economy. Note too that the loans in the chart above originated in 2006; the loans originated in 2007 were, if anything, of poorer quality than the 2006 loans. That means that even without a worsening economy the default rates to come next year and the year thereafter may be even more severe.

- We provided these findings to the Congressional Oversight Panel, which included the chart above in its 3/6/09 report, where it appears as Chart 12.

- All the other data that the Congressional Oversight Panel was able to collect confirmed Ellington's findings that negative equity is driving default rates to alarming levels and will continue to do so

  - Chart 10 in the 3/6/09 report of the Panel, p. 27 reports data on defaults compiled by Office of the Comptroller of the Currency and the Office of Thrift Supervision. The Panel described this chart as follows:

    - "As Chart 10 shows, negative equity is the single best indicator that a property is likely to enter foreclosure for this data set." COP 3/6/09 report, p. 32.

  - Chart 11 in the 3/6/09 COP report reflects data collected by the Panel from Indy/Mac Portfolio of Loans. As the Panel notes the Indy Mac data shows that negative equity is surpassed only by negative amortization as the best predictor of default and many negative amortization loans "are likely [to have] negative equity." COP 3/6/09 report at p. 32

  - The International Monetary Fund report issued on 2/19/09 also recognizes the importance of addressing negative equity. For example, the abstract at the beginning of that report says: "[T]he key problem is a combination of negative housing equity and unaffordable debt service, and a successful loan modification scheme should address both issues." International Monetary Fund Report: Foreclosure Mitigation Efforts in the United States: Approaches and Challenges, 2/19/09, prepared by the Monetary and Capital Markets and Western Hemisphere Departments (John Kiff and Vladimir Klyuev).

- **Perverse Incentives of Servicers are Exacerbated, Not Cured by President's Plan**

  - It serves servicers' interests, but not homeowners and not bondholders, to reduce interest on every loan in danger of default.

    - Servicers are paid a percentage of principal for each house that is not defaulting. That means reducing interest costs them nothing and gains them much, at least in the short term, i.e., until the homeowner redefaults. But those gains are at the expense of bondholders, who bear the cost of interest reduction and will ultimately bear the even greater cost when these loans redefault. Those gains are also at the expense of homeowners who are encouraged to keep paying on a home they will still not end up owning—pouring good money after bad.

- The threat of redefaults down the road are not enough to dissuade servicers from reducing interest rates because in the current environment, all servicers are driven by their immediate needs (short term goals), not the long term.

    - Small servicers, i.e., those not a subsidiary of a major financial institutions, are cash strapped because they have to pay into the pool in lieu of defaulting homeowners—a huge expense that they can only recoup upon foreclosure (thus many foreclosures take place even when a good modification would yield more money for bondholders, a point we return to later) or when the loan is modified (no matter how unlikely the modification is to last over the long term).

    - The President's plan assumes they are cash strapped primarily because their fee arrangements with bondholders did not contemplate so much work to be done foreclosing and modifying and thus justifies paying servicers a fee for modifying by reducing interest rates, something servicers already have plenty of incentive to do.

    - Indeed, I have seen data showing that the most cash strapped of the small servicers are modifying (by reducing interest rates) at a rate three times that of other servicers. That is no surprise given their desperate need to conserve cash and avoid paying advances on defaulting loans.

    - The large servicers, i.e., those that are subsidiaries of the major banks, are not cash strapped, but for them too, it is all gain and little pain to reduce interest in lieu of reducing principal. The incentives of the major bank/servicers is an important part of this story, which I explain at the end of this section. Here, let it suffice to say that by reducing interest instead of principal, the big bank/servicers can avoid – in the short term-- writing down the loans in their portfolio, thus bolstering, at least temporarily, their balance sheets, while passing the costs of reducing interest on to bondholders. And they too are oriented toward the short term at the moment, a point I return to later, so that the fact that so many of the interest-reduction-modifications will ultimately redefault, and force them to write the loans down much further, is not of primary concern.

- Paying servicers to do what they would happily do for free were it not for the threat of lawsuits from the bondholders (already an insufficient threat to deter the most cash strapped servicers), while **immunizing** these conflicted agents is a recipe for disaster. This encourages quick and dirty modifications aimed at the short term that will do little good. This misalignment of interests between servicers and bondholders is the reason the contracts between bondholders and servicers restricted the number and kinds of modifications servicers could perform.

- Those contract provisions are now imposing enormous externalities on neighborhoods, homeowners and even harming bondholders from getting modifications that would maximize the money they could realize from their mortgage backed securities. But removing those restrictions and leaving the servicers (with their perverse incentives to modify to help themselves and no one else) is not the solution. It will just cause more problems. That is why we proposed getting rid of the contract provisions imposing these enormous costs on all of us, but only in conjunction with replacing the servicers with government hired trustees, community banks. (see Geanakoplos, Koniak, NY Times, Mortgage Justice is Blind, 10/30/09; and the outline for legislation to implement our plan attached to this testimony).

- Servicers have an incentive, and will continue to have an incentive under the President's plan, to foreclose even when reducing principal would yield more money for bondholders and keep homeowners in their homes. The President's plan does nothing to to change this incentive.

  - As noted above, servicers have to pay into the pool in lieu of defaulting homeowners. Servicers get to recoup that money when they foreclose. This gives servicers an incentive to foreclose as quickly as possible on everyone who does not qualify for interest reduction under the President's plan and on all those who are currently seriously delinquent, even when a principal reduction would yield more for bondholders and keep those homeowners in place, thus stabilizing neighborhoods and supporting the value of the so-called toxic assets.

  - The President's Plan only considers whether more money can be realized by a modification of a mortgage than by foreclosure for those homes that meet the rather restrictive requirements of his plan, e.g., no more than 105% under water at the time the loan is considered for the limited kinds of modifications considered legitimate under his plan.

    - Whether more money can be realized from modification, including modification by principal reduction, versus foreclosure is, however, the key to an economically sensible result for homeowner, bondholder, neighborhoods and all taxpayers who have an interest in supporting the value of the bonds at the heart of the financial crisis, even if they rent and do not own a home.

    - No reasonable "moral hazard" argument can be made against reducing principal for homeowners who become seriously underwater and can reasonably be expected to pay a reworked mortgage. First, the decline in housing values that causes them to go underwater is not their individual doing. Second, no homeowner can force a lender to give her a loan that is worth as much or more than the house. Finally, setting a precedent that in the face of a once in 50 years decline in general housing prices, homeowners could expect principal reductions, would not be a bad idea. That is in fact what should be done in such circumstances. And lenders should take into account that in those circumstances the government might intervene to encourage principal reductions when it improves the cash flows paid by the homeowners. If anything, that should make bondholders more likely, not less likely, to make new loans. Indeed, standardized contracts for future securities might well include or be required to include provisions for principal reductions in the event of a future cataclysmic decline in housing prices like that we are now experiencing.

    - The moral hazard that we need to guard against is that of mortgage originators, bondholders and servicers. All of those players need to understand that reckless lending and reckless securitizing costs them money. That is why our plan leaves the cost of principal reduction where it should lay-- on the backs of these actors.

    - On the other hand, bondholders--those who invested in the past and those we need to invest in the future in (more safely constructed) securitized loan products so that our credit markets start working again--should not be wiped out by foreclosures that make no economic sense and leave people homeless just because servicers need money or have an interest in artificially inflating their balance sheets in the short term.

- Big bank servicers have an incentive to protect second liens at the expense of first lien holders—something the President's plan encourages

    - Mortgages securitized by the private sector are a huge source of the current problem, and a primary target of the President's plan. But what the plan ignores is that those securitized mortgages are first mortgages and an enormous number of the homeowners with those first mortgages also have second liens on their property. (For example, one category of securitized mortgages were done 80/20 at origination, i.e., 80% first mortgage and 20% second mortgage. By definition, all those people are subject to 1st and 2nd liens.

- The second or junior mortgages, however, that are attached to the securitized first mortgages were generally not securitized. Where are they? They are largely being held as whole assets on the books of the major banks.

- Under the President's plan, a big bank servicer can reduce interest payments on the first without reducing the second (junior) obligations. This flips the priority of creditors on its head: allowing junior interests to collect 100% (interest and principal) while reducing the money owed senior interest holders. It is interesting, to put it mildly, that no one is discussing the "moral hazard" or perverse future consequences on markets of this reversal of creditor position, while we are bombarded daily with talk about the "dangers" of moral hazard and perverse future consequences on the mortgage market of reducing principal for stressed homeowners.

- This hidden feature of the President's program is quite consequential. First, it is hidden.

  - In the guidelines issued by the Treasury, there are only two mentions of junior liens.

  - First, junior liens are to be taken into account (along with all other homeowner debt) in calculating what the plan calls back-end dti (debt to income). Notice that in determining initial threshold eligibility for the program (front-end dti), only the first mortgage is considered, which is consistent with the idea that the loans that the plan contemplates being modified are the first mortgages alone and not the seconds.

  - But we need not guess about the plan's intent to reduce interest on 1st mortgages and not seconds, because the only other mention of junior liens, however, vague and innocent looking on its face, demonstrates that a flipping of creditor priority is contemplated. The guidelines state:

  - "To reduce the borrower's overall indebtedness and improve loan performance, additional incentives will be provided to extinguish junior liens on homes with first-lien loans that are modified under the program." Home Affordable [sic] Modification Guidelines, March 4, 2009, under the Subheading: **Second Lien Elimination Payments**

        - The only sensible reading of that elusive paragraph is that the federal government intends to pay off the second lien holders, who just happen to be the major banks—institutions already the beneficiaries of taxpayer largesse with little or no conditions. I want to be clear: I am not here criticizing taxpayer support for the financial system, including the major banks, which is also not to say that I approve of the method in which the government has gone about doing that—that method is simply not the subject of my testimony today.

        - What I am saying is that paying off second lien holders while leaving first mortgage holders to take a substantial hit and at the mercy of servicers whose interests are not aligned with those of the first bondholders cannot be justified as economically sound. I am also saying that burying this matter in the guidelines and alluding to vague payments-to-come to second lien holders, not identified as the major banks, as in the interest of homeowners [whose interests are not well served by this overall plan] instead of payoffs to the banks is not consistent with the transparency our government has promised and which it owes the citizens of this country.

    - What are those 2nd liens worth? And what does the government intend to pay for them? To stabilize our economy—both Main Street and Wall Street—we need to stanch the avalanche of foreclosures that will come from the homes now (and soon to be) underwater. The way to do that is to reduce principal when a homeowner can reasonably be expected to make mortgage payments over time that would yield more money than foreclosing. But if the first mortgage holders are not going to get 100% of the principal repaid, then the second mortgage holders are entitled to nothing. Yet they have somehow managed to get much more than that. How?

        - As the Congressional Oversight Panel says in its 3/6/09 report: "Out of the money junior mortgagees will consent to subordination only if they are paid. Thus, junior mortgages pose a serious holdup for refinancings, demanding a ransom in order to permit a refinancing to proceed.". COP report 3/6/09 at 37.

- Why would the big banks and some bondholders resist writing down principal and support an interest reduction plan when that plan is bound to lead to massive redefaults down the road?

    - There still remains an unanswered question: why do a few bondholders and the major banks, the holders of many securities based on mortgages bound to redefault down the road unless principal reduction is part of the modification plan, vehemently resist principal reduction? If it will make them better off in the long run, why not push for it now? This brings me to the short term time horizon of the banks that I alluded to above.

- The major banks and some bondholders still hope that the federal government will come in and buy up all their bad mortgages and the toxic assets associated with these mortgages. They understand that if that dream comes true and the government decides that such a massive bailout is necessary, the government will not buy the assets at full value, but will insist on some "haircut," reduction from full value.

- A modification plan that reduces interest, but leaves principal untouched, allows the banks to start their hoped for negotiation with the government over what the loans (and other assets are worth) with 100% of the original loan as the starting point. It also allows the banks to carry assets tied to first and 2nd mortgages on their books as if the full principal will someday be paid, no matter the data that says without principal reduction a staggering number of the modified loans will fail.

- These are banks now being put through a "stress test" by the government to determine their future capital requirements and a mortgage plan that required principal reduction and required write of offs of many 2nd liens would reveal a truer picture of the banks financial condition.

- But the banks have little interest in presenting that truer picture. We can only hope that the federal government will come to understand before it is too late that the mortgage plan it has put forth not only will not stop the hemorrhage of foreclosures but also serves to mask the true financial condition of the banks that are so central to our economic future.

- The major banks are a formidable obstacle to sensible modification efforts that includes principal reduction because they want money for their bad investments. Despite the somewhat illusory value of the 2nd liens and the long term prospect of even lower value for 1st liens and the complex securities built upon those 1st mortages, the big banks seem to be calling the tune. The major banks are playing multiple roles—as asset holders, as servicers, as essential lynch-pins to our nation's economic health. Thus, their already strong voices are magnified and drown out data and analysis that demonstrates they are leading us down the wrong path.

- To stabilize Main Street and Wall Street, we need to stanch flood of foreclosures to come from the many homeowners whose mortgages are underwater (or upside down). To do that, we have to bite the bullet and help (first mortgage) bondholders do what is in their best interests—start writing down principal---a solution which rigid contracts and diverging interests prevent bondholders from reaching on their own – a collective action problem that is imposing huge externalities on the rest of the country. The second lien holders have to get out of the way and take their losses; and the servicers (much the same group as the second lien holders) have to be replaced.

- A Plan That Will Work---The Blind Trustee Solution

  On October 30, 2008, Professor Koniak and I laid out some of the problems I have detailed more fully here and laid out the broad outlines of a plan to solve the foreclosure problem in a manner that helps both homeowners and bondholders.

  This testimony is long enough, so I will not rehash all the details of that plan here, but instead refer to you the October and follow-up March op-eds, which I attach, and the outline of a bill that would implement our plan, which fills in broad strokes provided in the op-eds.

  In short, our plan would by legislation remove all restrictions on the number and kinds of modifications permissible in securitized mortgages and transfer the responsibility of deciding whether and how to modify a loan or whether to recommend foreclosure from the servicers to trustees, hired by the government, to do the job free from the perverse incentives of the servicers.

  The only cost to the taxpayer contemplated by our plan is the cost of hiring the trustees, which we estimate at 3 to 5 billion dollars over the three years we anticipate they would have to be in place.

  The trustees would be charged with modifying all loans, including reducing principal for homeowners underwater, whenever it was reasonable to expect a homeowner to be able to pay more than the home would bring in foreclosure.

  The cost of the writing down of principal or other modification terms would be born by the bondholders, not the taxpayers. The problem of moral hazard for bondholders in the future would thus be addressed and taxpayer money would be saved. The servicers would be entitled to whatever payments they are entitled to under their present contracts, but would be divested of the ability to use their powers to drain cash from bondholders by recklessly reducing interest instead of principal or to harm homeowners and bondholders by foreclosing to recoup their money when reducing principal would leave a homeowner in her home and pay bondholders more than they would realize at foreclosure.

  Moreover, unlike bankruptcy, our plan builds in an incentive for homeowners now current in their mortgage payments to continue paying until the trustees arrive for a modification review. We provide that anyone now current who defaults before a trustee decides on whether a modification (including reduction of principal) makes economic sense is presumed ineligible for our program unless the person can show a serious unavoidable intervening adverse economic change in circumstance, such as job loss or outsize medical expenses.

  This plan would not only help homeowners; it would also help bondholders. There is room to make generous principal reductions, without hurting bondholders and without spending a dime of taxpayer money, because the bond markets expect so little out of foreclosures. Typically, a homeowner fights off eviction for 18 months, making no mortgage payments, no tax payments and no repairs. Abandoned homes are often stripped and vandalized. Foreclosure and reselling expenses are so high the subprime bond market trades now as if it expects only 25 percent back on a loan when there is a foreclosure.

The taxpayers need not and should not be responsible for making up the difference between the payments due bondholders before a loan is modified, and those due after modification. Why? Because the bondholders and the banks, the ultimate beneficiaries of homeowner monthly payments, will be better off if mortgages are modified correctly and foreclosures stopped. They will benefit from the intervention we propose; the government "owes" them nothing more than that.

In the example, we provided above of the homeowner with a $200,000 loan that is underwater, the bond market now values that loan at $70,000 because of the high probability of default and the pathetic amounts realized upon foreclosure. By adopting our program and setting out standards that would allow the bond market to anticipate a write down to $160,000 with a much high probability that the homeowner will not default because she now has equity, the bond market will value that bond somewhere much closer to $160,000 than the $70,000 it now expects.

Thank you for the opportunity to present this written testimony and the material I've attached, which is:

1. John D. Geanakoplos[2] and Susan P. Koniak,[3] Matters of Principal, NY Times, 10/30/08 Mortgage
2. John D. Geanakoplos and Susan P. Koniak, Mortgage Justice is Blind, NY Times 3/05/09
3. George M. Cohen,[4] Susan P. Koniak and John D. Geankoplos Blind Trustee Bill—revised outline
4. David A. Dana,[5] Discussion of Takings Clause of Constitution and the Blind Trustee Plan
5. David A. Dana, The Feudal Mistake
6. Biographical Information on Witness John D. Geanakoplos: brief bio summary and CV
7. The Committee's Required Truth in Testimony Disclosure Form

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[2] James Tobin, Professor of Economics, Yale University
[3] Professor of Law, Boston University
[4] Brokaw Professor of Corporate Law, University of Virginia School of Law
[5] Associate Dean, Northwestern University Law School

Matters
Of Principal

Sorry, but we simply have to save those who took out bad home loans.

By John D. Geanakoplos .

and Susan P. Koniak .

John D. Geanakoplos is a professor of economics at Yale and a partner in a hedge fund that trades in mortgage securities. Susan P. Koniak is a law professor at Boston University.

TO stanch the hemorrhage of foreclosures, we don't need another bailout. What we need is a fix — and the wisdom to see what is in our own self-interest.

An avalanche of foreclosures is coming — as many as eight million in the next several years. The plan announced by the White House will not stop foreclosures because it concentrates on reducing interest payments, not reducing principal for those who owe more than their homes are worth. The plan wastes taxpayer money and won't fix the problem.

For subprime and other non-prime loans, which account for more than half of all foreclosures, the best thing to do for the homeowners and for the bondholders is to write down principal far enough so that each homeowner will have equity in his house and thus an incentive to pay and not default again down the line. This is also best for taxpayers, who now effectively guarantee these mortgages because of the various deals we've made to support the banks

For these non-prime mortgages, there is room to make generous principal reductions, without hurting bondholders and without spending a dime of taxpayer money, because the bond markets expect so little out of foreclosures. Typically, a homeowner fights off eviction for 18 months, making no mortgage payments, no tax payments and no repairs. Abandoned homes are often stripped and vandalized. Foreclosure and reselling expenses are so high the subprime bond market trades now as if it expects only 25 percent back on a loan when there is a foreclosure.

The taxpayers need not and should not be responsible for making up the difference between the payments due bondholders before a loan is modified, and those due after modification. Why? Because the bondholders and the banks, the ultimate beneficiaries of homeowner payments, will be better off if mortgages are modified correctly and foreclosures stopped. The government “owes” them nothing more than that.

Why is writing down principal, which the Obama plan rejects, so critical to stopping foreclosures? The accompanying chart, courtesy of Ellington Management, an investment firm in Old Greenwich, Conn., tells the story.

It shows that monthly default rates for subprime mortgages and other non-prime mortgages are stunningly sensitive to whether a homeowner has an ownership stake in his home. Every month, another 8 percent of the subprime homeowners whose mortgages (first plus any others) are 160 percent of the estimated value of their houses become seriously delinquent. On the other hand, subprime homeowners whose loans are worth 60 percent of the current value of their house become delinquent at a rate of only 1 percent per month.

Despite all the job losses and economic uncertainty, almost all owners with real equity in their homes, are finding a way to pay off their loans. It is those “underwater” on their mortgages — with homes worth less than their loans — who are defaulting, but who, given equity in their homes, will find a way to pay. They are not evil or irresponsible; they are defaulting because — for anyone with an already compromised credit rating — it is the economically prudent thing to do.

Think of a couple with a combined income of $75,000. They took out a subprime mortgage for $280,000, but their house has depreciated to a value today of $200,000. They’ve been paying their mortgage each month, about $25,000 a year at a 9 percent rate including principal and interest. But the interest rate is not the problem. The real problem is that the couple no longer “own” this house in any meaningful sense of the word.

Selling it isn’t an option; that would just leave them $80,000 in the hole. After taxes, $80,000 is one and a half years of this couple’s income. And if they sacrifice one-and-a-half years of their working lives, they will still not get a penny when they sell their home.

This couple could rent a comparable home for $10,000 a year, less than half of their current mortgage payments — a sensible cushion to seek in these hard times. Yes, walking away from their home will further weaken their credit rating and disrupt their lives, but pouring good money after bad on a home they do not really own is costlier still.

President Obama's plan does nothing to change the basic economic calculation this hard-pressed family and millions of others like it must make. The Obama strategy — which involves reducing their interest rate for five years and giving them, at most, $5,000 for principal reduction over five years — will still leave them paying much more than the $10,000 it would cost to rent.

And five years later, after the Obama plan has run its course, this couple will still not "own" this house. Those who accept an interest modification under President Obama's plan are likely to realize at some point that they are essentially "renting" a home and paying more than any actual renter would. Many of those families will re-default, and see their homes foreclosed.

Bondholders today anticipate making as little as $70,000 on a foreclosed home like that in our example. But consider how much might change simply by writing down the principal from $280,000 to $160,000, 20 percent below the current appraised value of the house. The homeowner might become eligible to refinance the $160,000 loan into a government loan at 5 percent, which would be impossible on the $280,000 mortgage.

Even if the couple couldn't refinance and still had to pay the original rate of 9 percent, the payments would be reduced to $14,400 a year, considerably less than the $25,000 now owed, and no longer wildly more than renting would cost. And the couple would have $40,000 of equity in the house: a reason to continue to pay, or to spruce up the house and find a buyer. Either way, the original bondholders would have a very good chance of making $160,000, instead of the $70,000 expected now. Everybody wins.

If writing down principal is such a good idea, why aren't banks and servicers (the companies that manage the pools of mortgages that have been turned into investment vehicles) doing it now? Many banks are not marking their mortgages down to the foreclosure values the market foresees, hoping instead that we taxpayers will buy out mortgages at near their original inflated value—another government bailout. Reducing principal would force them to take an immediate markdown, but a smaller one. The servicers, meanwhile, are afraid that bondholders, their clients, will sue them if they write down principal — a real prospect because the contracts that allow servicers to modify securitized mortgages put restrictions on the kinds and number of modifications they may make.Moreover, making sound modification decisions is costly; servicers don't want to spend the money and lack the personnel to do the job.

Beyond all that, the servicers have a conflict that all but guarantees they will not modify loans to maximize bondholder value. Once a homeowner is in default, the servicer must advance that homeowner's monthly payments to the bondholders, getting repaid itself only when the house is sold or the loan is modified. So cash-strapped servicers want to foreclose prematurely or do a quick-and-dirty modification (without due diligence and thus without considering principal reduction) to get their money back fast.

Paying servicers, these conflicted agents, $1,000 per mortgage to reduce interest payments, as the Obama plan provides, is a bad use of scarce federal dollars. Last October, on this page, we proposed that Washington pass legislation that would remove the right to modify loans or decide on foreclosure from the servicers and give it to community banks hired by the government. These community organizations would have the power to modify mortgages (including reducing principal) when doing so would bring in more money than foreclosure — particularly loans that are now current but are in danger of delinquency. Those now current would be presumed ineligible if they default before the trustees arrive to modify. Our plan is simple and would require little government spending, somewhere $3 billion to $5 billion over three years, as opposed to the $75 billion or higher price tag for President Obama's plan.

We know there are some who will be outraged at the idea that their neighbors might get a break, while they — so much more responsible — get nothing. To these outraged folks we say, you would benefit too. It is not just your home values and your neighborhoods that will deteriorate if you insist that your underwater neighbors not get relief; it is your tax dollars and that of your children that will be needed to make up for the plummeting value of those toxic assets held by banks, which we taxpayers now guarantee and may soon own outright. It is your job that will be at stake when your neighbors can no longer afford to buy goods and services, causing more companies to cut jobs. So you need to act responsibly again, for your own sake and for the welfare and future prosperity of the entire nation.

Mortgage and Securities Stabilization, Recovery and Modification Program Act of 2009
Drafted by
George M. Cohen[*], Susan P. Koniak[‡] and John D. Geanakoplos[§]

Purpose of Bill: To reduce foreclosures and stabilize housing and securities prices by establishing a program for nonconforming securitized mortgages [and conforming securitized mortgages backed by Fannie Mae and Freddie Mac?] that transfers responsibility for mortgage modifications and foreclosure decisions from servicers to government-designated, community-based trustees, and removes any restrictions on those modification and foreclosure decisions found in private pooling and servicing agreements.

The bill would include the following provisions:

- Mortgages Covered by this Program: Covered mortgages include nonconforming [and conforming?] mortgages (including subprime, Alt-A, and jumbos) securitized before date of enactment of this bill.

- Transfer/Expansion of Modification/Foreclosure Decision Rights; Changes to Securitization Documents:

  - Notwithstanding any contract provision to the contrary governing any pool of securitized mortgages covered by this program, all rights to modify and make decisions on whether to foreclose on mortgages will be transferred from the designated servicer (or equivalent party) to the trustee designated by the Office of Mortgage Modification (OMM) established by this bill.

    - The authority to make modification and foreclosure decisions will be transferred away from the servicers to OMM as of the date of enactment of this bill. OMM will then transfer this authority to a designed trustee as soon as possible after the bill's enactment.

  - Once transferred, the trustees will have full power to modify mortgages and to make foreclosure decisions according to the standards discussed in this bill, notwithstanding any contract provision to the contrary governing any pool of securitized mortgages covered by this program, including (but not limited to):

    - any restrictions on the number or type or terms of modifications

    - any prerequisite to modification that mortgages be currently delinquent or

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[‡] Professor of Law, Boston University
[§] James Tobin Professor of Economics, Yale

in default

- any need to get permission from any third party (such as a trustee or holders of mortgage-backed securities)
- any requirements that the modifications or foreclosures be done to maximize the value of a particular securitized pool of mortgages as a whole (as opposed to maximizing the value of an individual mortgage)

○ Once a mortgage is returned to the pool, notwithstanding any contract provision to the contrary governing any pool of securitized mortgages covered by this program, all servicers of such pools (or equivalent parties) must follow the directions of the trustees and OMM concerning modification and foreclosure.

○ Nothing in this act is intended to modify other rights and responsibilities of servicers of pools of securitized mortgages covered by this program, including:

- rights to fees
- responsibilities to collect mortgage payments from homeowners (as modified by the trustees)
- responsibilities to distribute payments to bondholders in accordance with their contracts
- responsibilities to carry out foreclosures (when directed by the trustees)
- [what about the right to sell mortgages out of the pool?]

○ Except to the extent that the bondholders are bound by the decisions of the trustees concerning modifications and foreclosures and the effect of those decisions on their payment streams, nothing in this bill affects the rights of bondholders to receive payments in accordance with the securitization contracts.

● <u>Establishment and Responsibilities of Office of Mortgage Modification (OMM)</u>:

○ An Office of Mortgage Modification (OMM) will be established to oversee the program. OMM will be located in an existing agency (e.g. HUD, FDIC, Treasury, FHLBB) to save costs.

○ OMM will collect all necessary mortgage information from servicers and servicers of covered mortgages. Servicers of covered mortgages will be required to provide this information.

- OMM will keep track of which pools the covered mortgages are in but will not pass that information on to the trustees who will rework them, and will establish procedures and take all reasonable and necessary steps to make sure information does not get passed on or acquired by the trustees.

- Similarly, OMM will keep track of which mortgages are assigned to which trustees, but will not pass on that information to the servicers to whom the mortgages will eventually be returned or the holders of securities associated with those mortgages. OMM will establish procedures and take all reasonable and necessary steps to make sure information does not get passed on or acquired by the servicers or securities holders.

- OMM responsibilities will include:

  - dividing the US into appropriate regions

  - identifying community banks and credit unions and taking applications from these organizations to serve as trustees (If feasible, selection of trustees should be done through regular government contracting bidding procedures. If that would process delay program implementation too long, this bill needs to create an exception.)

  - hiring and overseeing (and, if necessary, replacing) trustees in each region who would be responsible for reworking/foreclosure decisions and will be paid by OMM.

  - establishing standards and procedures for trustee decisions

  - collecting reworking or foreclosure decisions from trustees and passing such information on to servicers for implementation of trustee decisions

  - maintaining data on the performance of trustees for purposes of monitoring.

  - auditing servicer and trustee compliance with the provisions of this act

  - collecting information from servicers about all payments made pursuant to modifications made under this plan

  - notifying trustees of all payments made by homeowners and any problems reported by servicers to OMM, such as default or delinquency for appropriate action

- OMM will have the authority to enforce the provisions of this act by appropriate action.

- Eligibility to Serve as and Responsibilities of Government Mortgage Trustees:

  - Community banks, credit unions, other similar institutions, or individuals with comparable experience in local mortgage markets will be eligible to serve as trustees.

  - Effort will be made to insure that trustees include a fair representation of minority-owned and women-owned institutions.

  - Interested institutions must submit an application that includes:

    - relevant experience

    - a staffing plan for hiring and assigning personnel

    - budget proposal

    - disclosure of any ownership of or interest in any mortgage-backed securities by the institution or its personnel (or their close relatives). Conflicts of interest would not necessarily be disqualifying but the institution would have to propose an acceptable plan for mitigating any conflict (e.g. screening).

  - Responsibilities of trustees will include

    - getting current appraisals of covered mortgage properties and maintaining documents of these appraisals

    - acquiring, securing, and maintaining sufficient documentation relevant to homeowners' ability to make sustained repayments

    - evaluating mortgage files sent to them by OMM and deciding which mortgages they should attempt to modify under the established standards

    - taking pro-active steps to locate and make in-person contact (including knocking on doors if necessary) with homeowners holding covered mortgages that the trustees determine are appropriate for modification efforts

    - making all reasonable efforts to create, negotiate, and achieve agreement on modification plans in accordance with the standards detailed in this bill

    - reporting modification, foreclosure, or no-action decisions to OMM

    - for the duration of this act, monitoring payments by homeowners pursuant to approved modification plans

    - taking prompt action upon notice from OMM to respond to delinquencies or defaults occurring under approved modification plans

    - providing homeowners contact information for designated loan officers so that homeowners can contact that person with any difficulties or change in circumstances

  - Trustees must take steps to ensure that personnel and operations dedicated to the program are screened off from regular operations.

  - Trustees must make their offices available for spot audits of their trustee operations by appropriate government officials.

  - Trustees will be treated as independent government contractors, not government employees for purposes of other law.

  - Trustee decisions concerning modification and foreclosure are not appealable by servicers or holders of mortgage-backed securities for covered mortgages.

  - Trustees must take steps and establish procedures to ensure that they do not acquire any information relevant to securities (or CDS or other derivatives) connected with any covered mortgage. Trustees must report to OMM any improper information they acquire. Any attempt by servicers or securities holders to contact trustees or provide them with improper information or directly or indirectly to interfere with trustee activities will be criminally prosecuted.

- <u>Standards for Modifications of Loans</u>:

  - OMM will establish criteria that trustees must follow in making modification and foreclosure decisions. These criteria will include presumptions based on mortgage debt to income ratios determined by OMM.

  - The basic standard for modification will be that the expected payments from the homeowner pursuant to the modification must exceed the expected recovery from a foreclosure proceeding. The homeowner must reasonably be expected to be able to make and sustain these payments.

  - The standards will be consistent with the overall goals of keeping the homeowners in their homes to the extent possible, and, where possible, converting nonconforming mortgages into conforming mortgages

- The standards will include a provision stating that the homeowner need not be currently delinquent or in default to qualify for a modification.

- The standards will include a requirement that homeowners must demonstrate the ability to make and sustain payments required under a modification plan.

- The standards will include a presumption that the modification will include reduction in principal when the homeowner has negative equity in the house (appraised value of the house is less than the outstanding mortgage) and holds a subprime or Alt-A.mortgage

- The standards will describe acceptable forms of modifications, including

  - reduction in interest

  - deferral of principal

  - extended time for payment

  - reduction in principal.

- The standards will include a provision that requires a trustee who finds that any loan is not in reasonable risk of defaulting to designate the mortgage as "No Action Required" and return the file to OMM for return to the pool.

- The standards will include a presumption that any mortgage that becomes delinquent between the date of enactment [introduction?] of this bill and 6 months [?] after the date of enactment will not qualify for mortgage modification. The presumption may be overcome if the homeowner demonstrates a significant change in financial circumstances during that time period (e.g. job loss, major illness).

- Trustees may propose revisions to the modification standards either generally or to be applied in specific locations. OMM must approve any changes in standards.

● <u>Congressional and Administrative Oversight</u>:

- OMM will keep statistics and data and will prepare [quarterly] reports to be submitted to the GAO and Congress. These reports will include not only data supplied by the trustees, but also background data on different regions so that meaningful comparisons can be made among trustees to identify both insufficient and unjustifiable or excessive modifications or re-default rates.

- Efforts to improve performance: Within the first year of the program, the methods and structures of the best performing trustees will be assessed to develop a best practices list, to be implemented by trustees going forward.

- The GAO and Comptroller will produce quarterly reports to Congress [see TARP].

- Spot audits of OMM, trustee offices, [and servicers?] will be conducted by [FDIC?]

- Transparency: OMM will maintain a public website where all reports will be published.

- Ombudsman: OMM will designate an Ombudsman who will handle any complaints from homeowners or servicers. The Ombudsman will prepare separate reports to Congress.

- Termination of Program: The right of trustees under this program to make decisions on modification or foreclosure will terminate no later than three years after the date of enactment of this bill, unless re-authorized by Congress. [Other functions and responsibilities under the program will continue until all covered mortgages are resolved by payment in full, transfer, default and/or foreclosure, unless Congress provides otherwise by appropriate legislation.]

- Establishment of Task Force for Regulation of Future Mortgage and Other Private Securitizations:

  - A Task Force will be established to consider regulations to govern the securitizations of mortgages, with an emphasis on promoting efficient loan modification and foreclosure decisions, increasing transparency and oversight, clarifying fiduciary duties of agents of entities holding securitized assets, and preventing excessive leverage throughout the system.

  - The Task Force will also consider regulations of credit default swaps (CDS), with an emphasis on eliminating the ability to "overinsure" assets and increasing transparency and oversight.

  - [If new mortgage securitizations are created after the date of enactment of this bill and before Congress enacts new regulation, the task force/OMM should make a recommendation to Congress about whether it is advisable to expand the mortgages covered by this bill.]

- Funding for Program: [identify funding source and how money gets appropriated to

OMM for hiring of trustees.]

- Effect on Other Law [and accounting standards?]

  - Nothing in this act shall affect any previously existing tax status (i.e. REMIC) for entities holding securitized mortgages.

  - Nothing in this act is intended to affect any accounting treatment of securitized mortgages or the entities holding them (FAS 140).

  - The bill shall include any additional provisions necessary to preserve the tax and accounting treatment of securitized mortgage pools.

- Immunity:

  - Servicers of securitized pools of covered mortgages will be immune from liability only for transferring mortgages rights to OMM/trustees and accepting the modification/foreclosure decisions made by trustees under the program.

  - Servicers remain legally responsible for any actions or omissions taken before the enactment of this bill or for any actions not required by this bill.

  - Trustees will be immune from private suits in connection with decisions made in connection with the program [or immune to the extent that government contractors or other government agents are immune?]

Why the Takings Clause is not a Problem for the Blind Trustee Servicing Plan—A Quick Explanation

David Dana, Northwestern University

As Oliver Wendell Holmes explained over a century ago, government could "hardly go on" if every change in value of every property interest had to be compensated when the government implemented new regulation affecting market values.[1] Indeed, the Takings Clause guarantee of just compensation has been largely limited to intrusions on core indicia of land ownership -- notably the right to be free from permanent physical occupations. In the realm of commercial or economic regulation of personal property, as the United States Supreme Court has explained, private individuals and entities have no reasonable basis for expecting constancy in regulatory treatment. It is against that background – and not the background of cases involving zoning of land -- that a plan for mandatory transfer of mortgage servicing to blind trustees must be assessed. Moreover, even if we apply the land use cases regarding Takings to the blind trustee servicing plan ("servicing plan"), it is doubtful any investors could succeed on any Takings claims.

The starting point in any Takings Clause analysis is the identification of the relevant "property" that it is at issue. The Supreme Court has adamantly rejected "conceptual severance" – the severing of an investment into discrete elements, so as to isolate some element that has been wiped out by new government regulation. Instead, the Court has held that the economic investment as a whole must be considered in evaluating how much new government regulation has resulted in a loss in fair market value. Viewed from this vantage, the relevant property that could be affected by the servicing plan is a given investor's financial interest in a pool of mortgages. If the servicing plan were to result in an investor receiving nothing from an investment in a pool when it otherwise would have received a significant sum of money, we could characterize the plan as resulting in the elimination or cancellation of an interest in property. But the servicing plan is likely to instead result in investors sometimes receiving more from their investment in the pool, and perhaps sometimes receiving less than they otherwise would have. But investors could not establish –and under clear doctrine it would be their burden to establish – that their financial interest in a pool was "wiped out" by the servicing plan. Indeed, it seems unlikely they would be able to carry their burden of proof of quantifying any financial losses they incurred at all as a result of the servicing plan.

Even if the investors could indeed show some partial losses or reduction in the value of their property as investment in the mortgage pool, that would decidedly not mean that a Taking had occurred. Under the applicable *Penn Central Transportation v City of New York*[2] framework, partial reductions in value of a property have generally not been found compensable. In deciding whether such partial losses are compensable, key factors for the court to consider are: (1) the extent to which the character of the government regulation infringes on a traditional core aspect of property ownership, such a the right to physically exclude, (2) the property owner's "reasonable expectations", (3) the degree of "average reciprocity of advantage" – that is, the extent to which the affected property owner may benefit from as well as be burdened by the new regulation, and (4) the breadth or narrowness of the class or persons or entities affected by the new regulation, with the idea being that narrowly applied regulation warrants more concern because of the possibility of unfair discrimination against a vulnerable small minority. All of these *Penn Central* factors argue against a finding of any Taking as a result of the servicing plan. The servicing agreements underlying the pool investments generally allow for reworking of mortgages by the servicer, so investors in mortgage pools could not have any firm, reasonable expectation mortgages would not be reworked. Moreover, the residential housing market and mortgages in particular as a historical matter been the subject of intensive regulation and often massive new

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[1] ***Pennsylvania Coal v. Mahon*, 260 US 393 (1922).**
[2] **438 U.S. 104 (1978).**

regulation during housing market downturns, and investors in mortgage pools reasonably would have known as much. The servicing plan does not affect at all traditional indicia of property ownership, such as the right to physically exclude. There is clear average reciprocity of advantage, because investors will benefit from the overall stabilization of the housing market and hence the economy (and may indeed benefit from some share of the mortgage restructurings). Finally this plan would apply to a broad range of property owners, and would apply "blindly," so the equal protection concerns that are expressed in the Takings Clause jurisprudence would not be implicated. Like the adoption of a more progressive tax to raise revenue to decrease a federal deficit that threatens economic stability, the servicing plan would be broad-based, public-need-driven economic regulation of the sort the courts have held is a matter best left to democratic politics and not properly the subject of claims for just compensation under the Takings Clause.

The Feudal Mistake

David A. Dana, Northwestern University Law School

In recent years, mortgages have been carved up into so many pieces that the re-working of mortgages — and the saving of homes from foreclosure – is not happening even when there are responsible homeowners who are willing and able to make reasonable payments. History provides a clear lesson as to what Congress should do about this mess. In feudal England, trade in land was burdened by a legal system that recognized a myriad of current and future interests that could lay claim to any parcel. English and American judges created and used legal doctrines to undo the excessive fragmentation of ownership interests in land. Right now, Congress should take that legal history as inspiration and enact reforms that would allow the re-working of mortgages without the consent of all the owners of the securities that are in some way “backed” by or “derived” from troubled mortgages.

From the Seventeenth Century onward, English and American law encouraged the holding of land in what is called a “fee simple” – a kind of ownership where all the interests in the land are held by a single entity that can make economically rational land use decisions (including whether to sell the land to someone else who values it more). The judges promoted unified ownership of land through aggressive means, in some cases plainly rewriting wills and contracts to remove contingent or uncertain claims on land.

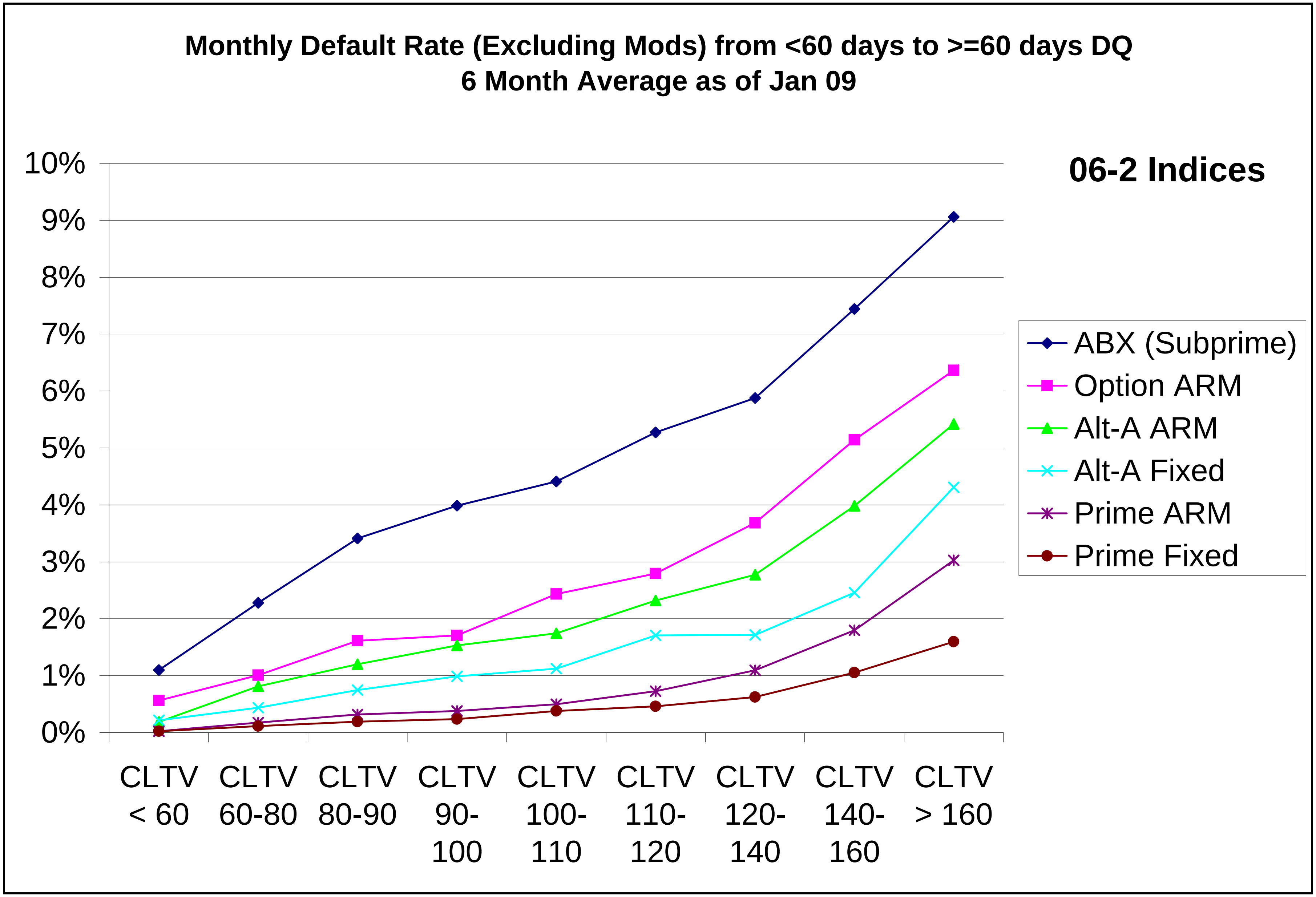
The recent developments in the mortgage-backed securities and derivatives markets prove the wisdom of the English and American judges. The structure for mortgage-backed securities that has been used in recent years makes re-working of mortgages a near impossibility. Some mortgage-backed securities holders benefit more if the mortgages do not go into default and the properties do not enter foreclosure, while others benefit more if the mortgages do go into default and the properties do enters into foreclosure. Because many mortgages are pooled in each security, hundreds or even thousands of investors may gain a tiny advantage from any single mortgage not going into default or instead going into default. Under these circumstances, it is not feasible to obtain the consent for a re-working of a mortgage from of all the investors who may have some kind of financial stake.

Congress should follow the path of post-feudal property law by eliminating any requirement that all investors in a mortgage consent to the re-working of the mortgage. Instead, government-appointed trustees should be authorized to employ the same criteria for re-working that a community bank traditionally would use when it holds a 100% stake in the mortgage. One of the criticisms of this plan to facilitate the re-working of mortgages has been that doing so may infringe upon the “property rights” of some of the investors in mortgage-backed securities and derivatives. But facilitating rational economic decisions by limiting the effects of fragmentation of ownership interests is consistent with – indeed central to -- the traditions of property law in England and America.

Moreover, since the New Deal, the courts have embraced the general principle that Congress can adopt economic or business regulation that modifies and limits private behavior and privileges so as to advance the public interest without triggering any government obligation to make adversely affected private parties whole.

In any case, the holders of interest in mortgage-backed securities and derivatives will not be wiped out by any government plan that facilitates the reworking of mortgages. The market in these securities is already in such disarray that the institutions that hold them have marked them down to cents on the dollar. Indeed, by placing the decision to rework or foreclose in the hands of agents capable of making economically sensible choices, the great uncertainty about the value of these securities will be eliminated, allowing trading in them to resume. Even more important, by bringing more closure and certainty to a chaotic landscape, government measures to promote mortgage reworking would stabilize the housing market.

Every major financial institution probably would benefit on net from the stabilization of the market in mortgage backed securities as well as the improvement in economic conditions more generally. As the late Justice Brennan explained, regulation that promotes what he called an “average reciprocity of advantage” is precisely what our government is supposed to aim for, and does not implicate the constitutional requirement of just compensation for the government taking of private property.


Monthly Default Rate (Excluding Mods) from <60 days to >=60 days DQ
6 Month Average as of Jan 09
06-2 Indices
10%
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
CLTV < 60
CLTV 60-80
CLTV 80-90
CLTV 90-100
CLTV 100-110
CLTV 110-120
CLTV 120-140
CLTV 140-160
CLTV > 160
ABX (Subprime)
Option ARM
Alt-A ARM
Alt-A Fixed
Prime ARM
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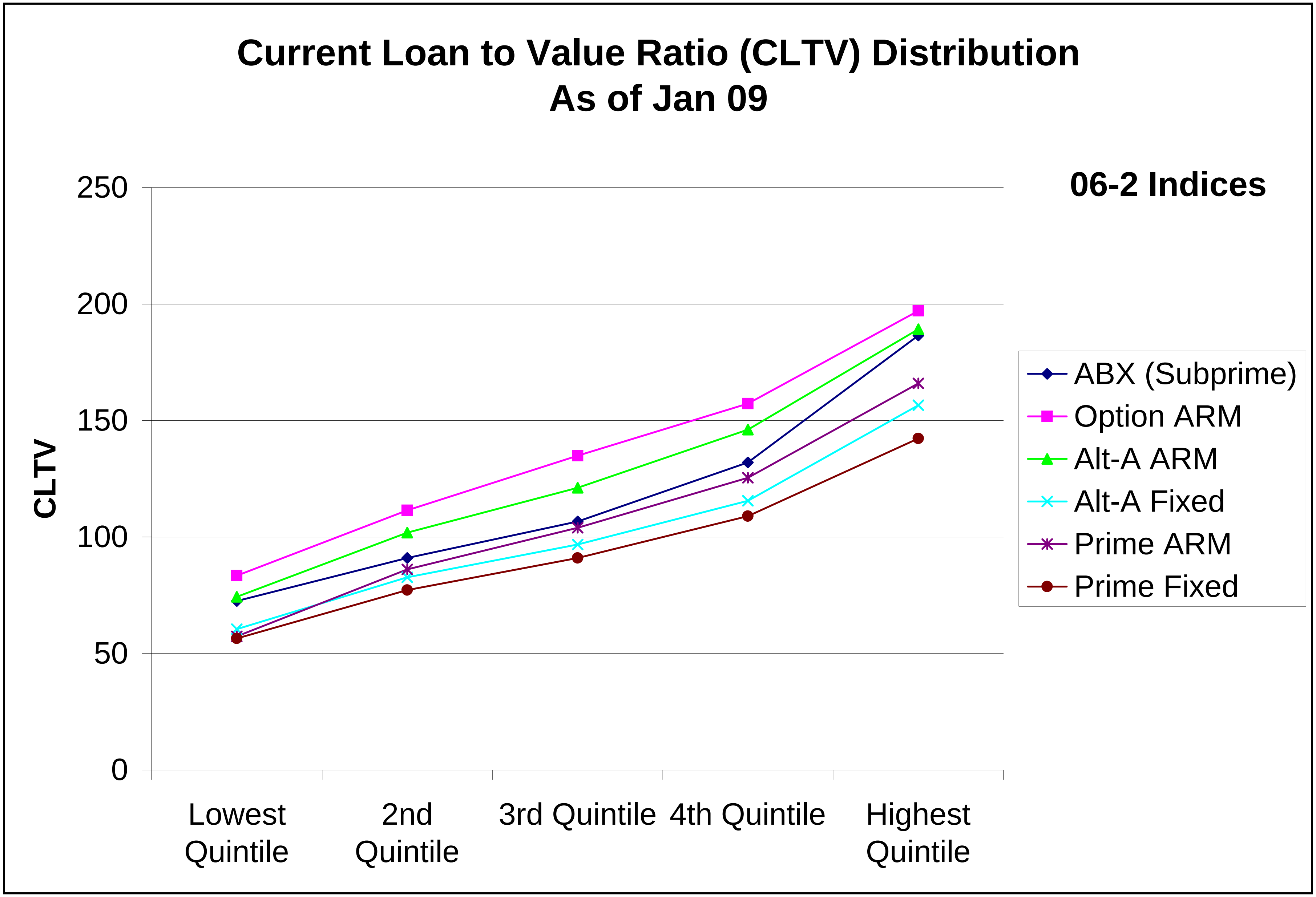

Current Loan to Value Ratio (CLTV) Distribution
As of Jan 09
06-2 Indices
CLTV
250
200
150
100
50
0
Lowest Quintile
2nd Quintile
3rd Quintile
4th Quintile
Highest Quintile
ABX (Subprime)
Option ARM
Alt-A ARM
Alt-A Fixed
Prime ARM
Prime Fixed

Corrections to Testimony Sent to Subcommittee 3/17/09
of John D. Geanakoplos
Corrections Sent 3/18/09
Testimony to be Delivered 3/19/09

Date: 3/18/09

The first footnote of the testimony I sent you yesterday to meet your deadline noted that there might be errors because I had so little time to prepare it, two days.

I have already found two errors and one ambiguity and wanted to notify the Subcommittee of them.

Page 9, paragraph beginning: The President's plan only considers…. The example is wrong. The President's plan is restrictive, but it does not impose any maximum or minimum loan to value ratios, so, in theory, someone with a home deeply underwater (150%, for example) could qualify for the plan. The main point, however, remains the same: the plan is built on interest reduction (and loan extension), not principal reduction, which is "permitted," although the government's "pitch-in" is based on debt to income, (government contributes to get debt to income ratio from 38% to 31%) even if principal is reduced.

Page 10: Beginning with the paragraph "The second or junior" mortgages …. ." Most second liens connected to non-prime loans **were** securitized, just as first mortgages were. Nonetheless, the basic point about the second liens remains; the second lien holders and the servicers of the second liens are holding up sensible modification plans, see p. 12 of my testimony, quoting Congressional Oversight Panel.

Page 2: I point out that immunizing servicers makes matters worse. It does. But my testimony is ambiguous on the source of this potential immunity. The President's foreclosure mitigation plan does not offer servicers immunity. But immunity for servicers was considered as part of the bankruptcy bill and there are various other proposals that push immunizing servicers as a solution to the foreclosure problem. My testimony explains why immunity would make matters worse. See section on servicer incentives.

The President's plan instead of offering servicers immunity affirms the restrictions built into servicer contracts that limit their ability to modify. Those provisions, as I state, on p. 8 of my testimony were designed to control servicer self-dealing at the expense of bondholders. But, as I also point out, they are now imposing mass externalities on homeowners, neighborhoods and the general economy. That is why I advocate removing them, but simultaneously transferring the power to modify away from servicers – otherwise the servicers will be unrestricted and free to serve their own interests at the expense of both bondholders and homeowners.