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Madame Chairwoman, Ranking Member Capito, and distinguished members of the subcommittee, it is an honor to be here today to discuss with you the President's recently announced Making Home Affordable Program and several proposals for Congress to consider to ensure the new program meets its projected goal of keeping up to nine million American families in their homes.

My name is Andrew Jakabovics. My testimony today is based on my work as the Associate Director for Housing and Economics at the Center for American Progress Action Fund, and ideas developed in consultation with members of the Mortgage Finance Working Group convened by the Center for American Progress. Shortcomings, of course, are my own.

Housing experts know that in most cases the highest and best occupants of a property are its current residents, but until last month there was no far-reaching, comprehensive, systematic, or standardized effort to offer already delinquent or at-risk homeowners' opportunities to save their homes from foreclosure. The Making Home Affordable Program has three elements: $200 billion for preferred stock purchases in Fannie Mae and Freddie Mac with the aim of keeping interest rates low for the mortgage market in general; the Home Affordable Refinance Program, which relaxes loan-to-value ratios for Fannie Mae and Freddie Mac to allow slightly underwater borrowers to take advantage of those same low rates in refinancing; and the Home Affordable Modification Program, or HAMP, which moves the servicing industry to make sustainable loan modifications at an anticipated cost of $75 billion. My remarks this morning will focus on the modification program.

HAMP is based on the simple truth that foreclosures are costly for nearly all involved: homeowners, mortgage lenders and investors, and communities across the country. The beauty of the program is that it requires servicers to do what is in the best interest of their customers—lenders and investors—by requiring them to offer modifications in a consistent manner on all loans for which they are responsible when modification maximizes the net present value of a mortgage compared to foreclosure.

The program, in short, aligns the interests of borrowers, lenders and investors when foreclosure is clearly not preferable to loan modifications for any of them, and helps stabilize housing prices in communities nationwide.

Success, however, is not guaranteed, which is why Congress, in your oversight capacity, and the administration, in drafting the contract with servicers and as a prerequisite for incentive payments, must put in place appropriate tools to measure success. Both the Bush administration's weak efforts and the more serious yet unsuccessful attempt initiated by Congress under the Hope for Homeowners program serve as reminders that it is not entirely predictable how such a large and diverse market involving many different financial institutions and millions of borrowers in a variety of circumstances will respond to a program encouraging modifications.

The Making Home Affordable program is thoughtfully designed and has every prospect of succeeding, but constant evaluation should be built into the program from the beginning so that if it isn't working—or even if some aspects are and some are not—then we will know these things quickly and take corrective action. As the program gets underway, now is the critical time to establish clear reporting requirements and benchmarks for servicers to meet.

HAMP is predicted to provide 3 million to 4 million homeowners with mortgage modifications over the next two years. Working off the low end of that range, it seems reasonable to set a performance benchmark of 750,000 modifications within six months. Or calculated another way, mortgage servicers should be expected to modify 25 percent of their troubled portfolios in the same timeframe. Because we do not have the luxury of waiting before evaluating the new program's success or failure—absent a concerted effort to modify loans, an estimated 9 million families will lose their homes over the next four years—basic metrics for success both for individual mortgage servicers and the program as a whole must be established.

I would also encourage Congress to take additional actions now, well in advance of our recommended six-month evaluation date, to provide the administration with the authority necessary to implement the suggested next steps should it become clear that the mortgage-modification benchmarks are not being met, either by the program as a whole or by servicers individually.

Program strengths

Turning first to the program's strengths, HAMP establishes a clear industry standard for mortgage modifications which, in addition to helping keep borrowers in their homes, helps servicers fulfill their legal obligations to maximize value for their customers, the home mortgage lenders and investors. Moreover, the servicing industry can safely make more modifications knowing they are protecting the long-term value of individual mortgages and the overall value of the mortgage-backed securities in which they were often bundled.

It is crucial to remember that the landscape in which we are operating is one in which servicers have a clear fiduciary duty, that is, a legal obligation under the terms of their contracts with the trusts, to maximize net present value. It is far from certain that to this point servicers have been meeting that obligation when they have chosen to foreclose

rather than modify loans, even though their own financial incentives favor foreclosure, namely their recapture of costs and fees off the top of any proceeds from the sale of the property. Nevertheless, the payments offered to servicers under the program may help realign servicers' incentives with their existing obligations and provide needed funds to build capacity to do the modifications.

In contrast to the direction offered to servicers under the Hope Now Alliance's June 2008 Mortgage Servicing Guidelines, which stressed loss mitigation, the modification program now in place is predicated on maximizing net present value. While this may seem like a semantic quibble—my sustainable modification might be your loss mitigation strategy—the two approaches are fundamentally different and lead to what we hope are radically different outcomes. Under the new program, sustainable modifications based on 31 percent debt-to-income are forward-looking, focusing on the borrower's ability to manage the debt service and protecting the long-term value to investors, whereas loss mitigation is effectively backwards-looking, entirely about narrowing the gap between what was owed and what was paid, often resulting in short-term gains that are ultimately wiped out by longer-term losses. It is inconceivable under HAMP that modification would lead to a rise in payments, as it did in 34 percent of Hope Now's modifications, as Alan White found in his recent study.

Establishing a clear industry standard is beneficial to homeowners as well as servicers because of the certainty it can provide. For many families seeking mortgage relief, it is the uncertainty of the outcome of their entreaties that can be most stressful. Housing counselors can tell you about the palpable relief that can come with a firm "no" as families can begin to make preparations to find new living accommodations. Standardization is beneficial to borrowers able to get help under the program as well, offering them the ability to approach a servicer with the necessary documentation and an understanding of the transparent calculations that makes them eligible. In that vein, servicers' contracts with Treasury should recognize borrowers as third-party beneficiaries.

With that in mind, I would urge the creation of a publicly available eligibility calculator, available at www.financialstability.gov or www.hopenow.com, to be used independently or with a housing counselor that would mimic the calculations done by participating servicers.

Measuring success: Setting clear program benchmarks

There is no single performance metric that unequivocally would determine an individual servicer's success or failure, and by extension, that of the program as a whole. For this reason, we suggest a range of measurements that might be appropriate, including comparing a servicer's modification and redefault rates to those of Fannie Mae and Freddie Mac. In short, we need both absolute and relative measures of modifications and redefaults.

There may be legitimate reasons servicers can't achieve the same rates of modifications as for loans guaranteed by Fannie Mae and Freddie Mac, but an initial test should be to make that comparison. The burden of proof should fall on the servicers to provide compelling evidence—based on their specific portfolios—of why they fell short of this baseline.

In exchange for the incentive payments to servicers—as much as $4,500 per mortgage—we have a right to demand a far greater level of transparency in reporting than is currently available. Either the treasury or the Congressional Oversight Panel should collect and publish monthly performance reports by participating servicer.

Knowing what is happening is obviously the first step, but the bigger question remains: Is it any good?

The number of modifications and percentages of serviced loans constitute simple baseline metrics to compare across servicers, but the deeper analytics I would like to see reported would include comparisons within serviced portfolios of loans owed by borrowers with high back-end ratios compared to those whose total indebtedness is lower. Those borrowers with high levels of indebtedness are more likely to redefault, so their modifications should be closely monitored to alert us of a possible need for program adjustments.

A crucial measurement of the program's success must be its ability to protect low-income and minority families from foreclosure. Congress and the administration should demand strict adherence to fair housing laws and should monitor individual servicers closely to ensure that all eligible borrowers receive assistance. Given the servicers' ability to choose an interest rate reduction or a principal reduction under the program, I would urge reporting the types of modifications offered by race and income as well.

Beyond individual servicers, the whole program as currently conceived may not serve low-income and minority borrowers properly, and if we see them disproportionately continuing to lose their homes, program rules must be changed.

Many live in communities hard hit by the foreclosure crisis, with significant declines in home values off the peak. Because of the high cost of proceeding to foreclosure, particularly the costs of securing and maintaining the homes, long holding periods, and steep discounts necessary to attract buyers, borrowers in those communities may be more likely to be offered modifications than in places with fewer foreclosures or other homes for sale whose property values have remained relatively stable.

Yet, minorities also have significantly higher unemployment rates than whites, and income is a crucial factor in determining eligibility for modifications. Assuming servicers do not voluntarily modify to a sustainable 31 percent of income without the incentive payments, families whose incomes would require reductions in interest rates below 2 percent to reach a 31 percent debt-to-income ratio would not be helped under the program.

It remains to be seen how house price trajectories will intersect with income trends, particularly as they relate to low-income and minority borrowers. The paucity of available data makes it difficult to predict which communities, both geographically and demographically, will be helped. I am hopeful that direct and indirect effects of the funds from the American Recovery and Reinvestment Act flowing to states and localities in short order will be successful in both preventing additional job losses as well as spurring new job creation. But recognizing the very real possibility that borrowers who receive help today may suffer future unemployment spells, preventing a second modification as the program currently does may limit the program's effectiveness when we measure redefault rates.

Creating additional tools and mandatory mechanisms to reduce foreclosures

This reporting and evaluation process outlined above may uncover significant barriers to modifications that are difficult to remedy within the existing context. One serious potential barrier may be servicer capacity, as many, including the Mortgage Bankers' Association, have recognized. If that proves to be the case, then the logical next step is to take mortgages out of their hands. The capacity of mortgage servicers to modify mortgages has been a problem since the foreclosure crisis first dawned over a year ago. Even with incentive payments to servicers, they may not have the necessary manpower and remain unwilling to invest in technology to handle the volume of calls we expect them to achieve.

If within a reasonable period of time—say three months or certainly no more than six months—it becomes clear that individual servicers are failing to meet the reasonable levels of modification activity expected, the time will have come to move from carrots to sticks. Similarly, if the HAMP effort does not meet the level of modification activity set out from the beginning, then more aggressive modification policies should be implemented across the board. These next steps are not without controversy, but they are specifically intended to increase the number of modifications.

These action-forcing mechanisms potentially include:

- Principal reduction.
- The exercise of the government's right of eminent domain on mortgage-backed securities.
- Changes to rules that govern so-called Real Estate Mortgage Investment Conduits in which individual mortgages have been bundled up, sliced into pieces, and sold to investors.
- Expanded bankruptcy provisions to help at-risk homeowners.

All of these mechanisms are complex, but I will touch upon them briefly here and refer those who want more information to the report I have submitted in conjunction with today's written testimony.

Principal reductions

If we find that over time a significant number of modifications end in redefaults, then principal reductions might be better as a first step in the modification process rather than the last. The HAMP effort relies heavily on interest rate reductions to quickly create sustainable mortgages, but principal write-downs and interest-rate reductions offer identical net present valuations over the full life of the loan. More aggressive action to offer relief to borrowers whose loans are held by servicers with poor redefault track records should therefore include principal write-downs to the current value of the property in conjunction with adjusting mortgage payments to the 31-percent debt-to-income ratio.

Similarly, if HAMP as a whole results in high rates of redefaults, then principal write-downs to the current value of the property should become the new modification standard. The propensity for borrowers to walk away from severely underwater loans improves the net present value calculation for principal balance write-downs compared to interest-rate adjustments for the same monthly payment. The reason: Calculating in the cost of foreclosure means it is probably better for lenders or investors holding these mortgages to go for principal reduction as a way to lessen redefault risk.

Applying eminent domain

If mortgage servicers are simply too slow to offer modifications, then the government can break the logjam by acquiring entire pools or individual whole loans contained in such pools via eminent domain, which allows the government to acquire private property for a larger public purpose. Under eminent domain, property holders are entitled to receive just compensation for their losses and have the right to sue the government if they believe the payment they received was less than fair market value of the property. In this context, existing investors would get paid out based on a fair market value of any individual mortgage or of the pool as a whole.

While eminent domain is most often used to purchase real estate outright, the power has also been extended to taking other forms of interest in real estate such as leases. Given that mortgages—and by extension, pools of mortgages—are also considered to be interests in real estate, the use of eminent domain should apply to them as well. After acquisition, the Treasury Department as sole owner of the mortgage or the pool would then be able to unilaterally modify loans by whatever means they choose, including writing down principal to the current value of the property. Subsequent Treasury-funded acquisitions of mortgages and mortgage-backed securities under eminent domain could be funded by resecuritizing modified mortgages through Ginnie Mae.

Eminent domain is unquestionably a powerful tool, and I recognize the potential political pitfalls in promoting it, but if we focus on what makes it attractive—getting mortgages or entire pools out of the hands of entities unable or unwilling to modify them and the opportunity for quick price discovery based on the standard net-present-value analysis—

then we may be able to fashion an equally sharp policy lever. Because the authority to purchase mortgages already exists under TARP, one possibility would be congressional action to explicitly create a safe harbor for participating servicers and defining the sale of an individual mortgage out of a pool as the legal equivalent of a short sale, which servicers have the authority to accept.

Using REMIC rules for a public purpose

There are at least three ways in which the regulations that govern Real Estate Mortgage Investment Conduits, or REMICs—which are tax-advantaged trusts that issue bonds backed by mortgages that have been pooled and sold into the trusts—could be modified to increase modifications. The simplest change would be to modify the REMIC rules that govern the treatment of the trusts holding securitized mortgages such that trusts with contracts that limit modifications would no longer be eligible for tax-advantaged REMIC status. Investors and trustees would probably restructure their contracts with servicers to eliminate restrictions on modifications to maintain REMIC status, and consequently, we should expect modification rates to rise accordingly.

Taking the idea of rescinding REMIC status for trusts whose contracts with servicers limit modifications one step further, REMIC status could also be revoked for mortgage pools that exceed a certain default or foreclosure rate. Just as above, where the threat of lost status will trigger modifications, this more aggressive regulatory change will provide strong impetus to minimize redefaults as well.

A variation on this concept would be to implement regulatory changes to make REMICs behave more similarly to pools of credit card loans and other asset-backed securities, which include an early amortization trigger that forces the issuer of the asset-backed securities to repurchase the pool. In the case of REMICs, however, instead of passing the mortgage pool back to the issuer, the pool could be passed to Fannie Mae or Freddie Mac for modification. Investor payouts in those instances would be based on calculations of pool value as under the eminent domain scenario, again with investors retaining the right to litigate perceived damages.

Expanded bankruptcy provisions

If mortgage servicers' efforts to modify loans prove to be weak, with a demonstrated lack of good faith efforts being made, then expanded access to relief in bankruptcy court for homeowners should be considered.

Should the House-passed bankruptcy bill return to the House or go to conference, I would urge consideration for amending the bill to sunset the five-year claw-back provision that would allow note holders to recapture up to 90 percent of profits generated on sale created by a judge's write-down of principal balance six months after enactment if modifications fail to meet the program's benchmarks.

Conclusion

In keeping with the Obama administration's belief in transparency and accountability, reporting requirements and benchmarks in its Home Affordable Mortgage Program should be established in short order. Should either mortgage servicers individually or the HAMP program fail to meet the suggested levels of modifications—750,000 modifications in the aggregate or 25 percent of individual servicers' mortgages within six months—then the need for additional tools and mandatory mechanisms will be clear. Now is the time to put those additional measures in place so that they can be rapidly implemented should the need arise.