**Testimony of Anthony B. Sanders**
**Committee on Financial Services**
**U.S. House of Representatives**
**Washington, D.C.**
**December 8, 2009**

Mr. Chairman and Members of the Committee:

Thank you for the invitation to testify before you today.

There are a variety of Federal government programs and initiatives for attempting to create more sustainable mortgage payments for borrowers in imminent risk of default on their home loans. I will focus my attention on the Obama Administration's "Making Home Affordable Program."

According to the "Making Home Affordable Program Servicer Performance Report Through October 2009," 920,000 trial modification plans have been offered to borrowers and there have been 651,000 trial modifications made. Given the "fall off the cliff" of housing prices in many states, the surge of unemployment and the evaporation of liquidity for banks and related institutions in the second half of 2007, I am frankly surprised that the servicing industry has moved so quickly to make loan modifications in such large numbers. This is especially true when one considers how the very nature of the residential servicing industry has changed since 2007 in terms of number of problem loans to be serviced so dramatically. With 14.4 percent of borrowers in foreclosure or delinquent on their mortgages (as of September), this creates an incredible challenge to the servicing industry.

It is a real challenge to servicers to make loan modifications succeed when 70 percent of modifications that have only interest rate cuts have gone into re-default after 12 months. If the loan modification affordability calculation, as done under HAMP, only uses the first lien position, taxes and insurance and fails to include home equity loans, car leases, credit card debt and other debt burdens, the failure of loan modifications is not unanticipated. And, as I mentioned in the House TARP hearings during November 2008, the negative equity problem in the "sand states" of California, Arizona, Nevada and Florida is going to be very, very challenging for the servicing industry; loan modifications must take into consideration the negative equity position of households to determine their likelihood of success for making mortgage payments.

But even if servicers continue with this incredible growth rate in trial loan modifications, it is unclear how many trial modifications will become permanent modifications. The most likely "conversion" rate of trial to permanent modifications is about 33%, although it could be even lower. And the re-default rate on those trial loans that survive the challenge of making three consecutive mortgage payments during the trial period will likely be about 50-60% or even higher.[1] Say that only 25% of borrowers

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[1] Lender Processing Services in late May 2009 reported that nationwide modification efforts as of April achieved a re-default rate of nearly 50% six months after modification (with the Office of the Comptroller of the Currency showing a 55% re-default rate within six months).

convert from trial to permanent modifications and then 50% of those go into re-default, that translates into 12.5 of eligible borrowers actually receiving permanent loan modifications and keeping them current. And it is entirely possible that the "success" rate could even fall below 10% of eligible loans.

**Why are so few loans expected to be permanent?**

There are several reasons why so few loan will make the transition from temporary modification to successful permanent modification.

The first reason for the projected failure rate is the degree to which many residential loans in the United States are in a negative equity situation. According to a Deutsche Bank research report, they are expecting 25 million homes to be in negative equity position.[2] Although negative equity in small amounts is not a problem, larger negative equity positions such as 125-150% LTV are difficult to modify (even if the HAMP allowed such large modifications). Therefore, permanent loan modifications in areas with large house price declines will be extremely difficult.

The second reason for the poor prediction for successful permanent loan modifications is the unemployment rate. While 10% report unemployment rate is bad enough, the true unemployment rate (including wage and salary curtailment) is closer to 17.5%. This is a very challenging obstacle to overcome for the servicing industry. When you combine high unemployment rates with a severe negative equity problem, this "perfect storm" of bad conditions places enormous burdens on the servicing industry.

The third reason for poor transition figures is documentation problem. To qualify for a trial loan modification, the HAMP program is following the stated income approach that does not require documentation. Like stated income loans, stated income qualification for temporary loan modification is a fertile ground for moral hazard problems where borrowers/applicants that are insulated from risk may behave differently from the way it would behave if it would be fully exposed to the risk. In this case, borrowers may not want to submit the required documentation since they may be denied for a permanent modification. While there have been stories of servicers making it "difficult" for borrowers to submit the necessary documentation, one has to consider the flip side of the argument. Borrowers may claim that the servicers are making it difficult to obtain documentation when, in fact, they may just simply be hoping that the permanent modification will be approved without full documentation. In fact, a recent article in the New York Times discusses how willing the servicers were to make loan modifications, only to find that borrowers were not completing the submission of the required paperwork.[3] This is not to say that some borrowers have not experienced "true" documentation problems, which would be consistent with the dramatic growth in demand for loan modifications through HAMP as servicing entities ramp-up their servicing efforts to meet the demand.

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[2] http://www.bloomberg.com/apps/news?pid=20603037&sid=adBYDzUMt68k

[3] http://www.nytimes.com/2009/12/04/business/economy/04norris.html

The fourth reason, also discussed in the aforementioned New York Times article, is that many borrowers are having trouble making their three consecutive mortgage payments during the trial modification period. In addition, borrowers may not qualify for the temporary modification by having 1) too much income, 2) not enough income, or 3) have a house that has fallen too much in value.

**Servicer performance and the Servicer Performance Report**

The Making Home Affordable Program provides a "Servicer Performance Report" that rank orders servicers in terms of "Active Trial Modifications as a Share of Estimated Eligible 60+ Day Delinquencies." The higher the ranking, the more active trial modifications the servicer is making.

The problem with this accounting method for "success" is that it does not control for servicers with loans in particularly hard hit areas such as "bubble" states like California, Arizona, Nevada and Florida. Servicers in states where house prices have collapsed, sometimes by as much as over 50%, are going to be **heavily** challenged to perform these loan modifications. When you add in the already high unemployment rate in these states, these are indeed challenging areas to perform loan modifications.

In addition, the highest unemployment rates by metropolitan area (as of September 2009) are Detroit (18.5%), Warren MI – suburb of Detroit (17.0%), Riverside CA (14.1%), Las Vegas NV (13.7%) and Los Angeles CA (12.7%). While Arizona has "only" a 9.1% unemployment rate, the difficulty of loan modifications must be considered when combined with the crash of housing prices that occurred there.[4] The states and metropolitan areas with the highest unemployment rates should be taken into consideration by Treasury when determining loan modification trial success rates.

My recommendation for reporting servicer performance is to adjust the service performance by percentage of loans in 1) bubble states and 2) Midwest "economic malaise" states such as Ohio and Michigan. In short, modifying loans in Nebraska is likely to be far easier than modifying loans in Arizona, Nevada or the Inland Empire of California. Therefore, servicers should be given additional credit for attempting to modify loans in these challenging areas.

**Why is there a low level of principal write-downs for underwater mortgages?**

When financial institutions and other holders of mortgages (investors) accept loan modifications, short sales and short payoffs, they take an immediate hit, causing them to reduce earnings and receive pressure from regulators to raise additional capital. To provide an incentive for financial institutions/investors to sell their distressed mortgage loans to the private markets, the government regulators, including the SEC, should allow financial institutions/investors to amortize the losses for up to 5 years to spread the accounting consequence of a loss over time. This would enable the financial institutions/investors to sell distressed assets from their books and free up funds to be invested elsewhere such as loans to small businesses. While programs like HAMP are meant to keep people in their houses, we need to provide an incentive to financial institution to avoid becoming "zombie banks"

[4] Anthony B. Sanders, "The Subprime Crisis and its Role in the Financial Crisis," *Journal of Housing Economics*, Volume 17, Issue 4, December 2008.

as has occurred in Japan. While the HAMP program might keep some people in their homes, the program maintains the loan with the lender and does not free funds for uses other than housing until the loan is paid off or refinanced. And with some of the 40-year extension of loan life for some of the modifications, this would mean that these loans would be on the balance sheets of the lenders/investors for almost a half century.

Once the financial institutions/investors can dispose of distressed loans from their portfolios, private market groups can acquire these loans and enact private market loan modifications.[5] In fact, allowing financial institutions/investors to sell their distressed assets without immediate devastating consequences would enable them to pursue loan modifications through their services more aggressively, if economically appropriate.

Another advantage of allowing financial institutions/investors to sell the assets without immediate adverse consequences is that is opens the door for more broad approaches to dealing with the foreclosure crisis such as 1) short payoffs, 2) short sales, 3) foreclosure, 4) conversion to leases and 5) broader loan modifications if they make economic sense. Particularly given the vacancy rates in many states in the housing market, conversion to leases makes sense given the comparatively low rental rates compared to mortgage payments. Private funds has offered interesting loan modification examples as converting the loan to a rental agreement with an option for the former borrower to purchase the house, a shared appreciation approach where the borrower shares part of the upside with the lender in return for a principal write-down on the loan.

Accounting changes to permit financial institutions/investors to remove their distressed assets from their books clearly dominate alternatives such as "cramdowns" or other judicial interventions into the mortgage market. Helping financial institutions/investors dispose of their distressed assets was one of the original purposes of TARP and we should now consider the wisdom of cleaning-up financial institution balance sheets rather than judicial interventions.

I welcome any questions and appreciate the opportunity to speak with you.

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[5] For example, Selene Residential Mortgage Opportunity Fund ("SRMOF") is a private fund that can purchase, service and restructure loans.