Written Testimony of Mark Zandi
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Mr. Chairman and members of the Committee, my name is Mark Zandi; I am the Chief Economist and Co-founder of Moody's Economy.com.

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I will make six points in my remarks. First, the nation's housing and mortgage markets are suffering an unprecedented downturn. Housing activity peaked two and half years ago, and since then home sales have fallen by approximately 35%, housing starts by nearly 50%, and house prices by 8%. Some two-thirds of the nation's housing markets are currently experiencing substantial price declines, with double-digit price declines occurring throughout Arizona, California, Florida, Nevada, the Northeast Corridor and the industrial Midwest. Further significant declines in housing construction and prices are likely through the end of the decade as a record amount of unsold housing inventory continues to mount given the ongoing turmoil in global financial markets and its impact on the mortgage securities market and thus mortgage lenders and the recent weakening in the broader economy and job market. There is now a broad consensus that national house prices will fall by no less than 15% from their peak to their eventual trough.[1] Even this disconcerting outlook assumes that the broader economy will avoid a full-blown recession and that the Federal Reserve will continue to ease monetary policy.

Second, residential mortgage loan defaults and foreclosures are surging and without further significant policy changes will continue to do so through the remainder of the decade. Falling housing values, resetting adjustable mortgages for recent subprime and Alt-A borrowers, tighter underwriting standards, and the weakening job market are conspiring to create the current unprecedented mortgage credit problems. According to very accurate data based on consumer credit files, there were 450,000 first mortgage loans in default (the first step in the foreclosure process) as of year-end 2007.[2] This equates to some 1.8 million defaults at an annualized pace. Even if mortgage loan modification efforts increase measurably in coming months, I expect almost 3 million mortgage loan defaults this year and next. Of these, 2 million homeowners will go through the entire foreclosure process and ultimately lose their homes. The impact on these households, their communities, and the broader economy will be substantial. Foreclosure sales are very costly after accounting for their substantial transaction costs, and serve to significantly depress already reeling housing markets, as foreclosed properties are generally sold at deep discounts to prevailing market prices. In much less stressful times, these discounts are estimated to be between 20% and 30%.[3]

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[1] See "Aftershock: Housing in the Wake of the Mortgage Meltdown," Moody's Economy.com, December 2007.
[2] The source of this data is a 5% random sample of all the nation's consumer credit files maintained by credit bureau Equifax. The sample is drawn at the end of every month.
[3] See "The Value of Foreclosed Property," Anthony Pennington-Cross, Federal Reserve Bank of St. Louis, September 2004. http://research.stlouisfed.org/wp/2004/2004-022.pdf. For an estimate of the impact of foreclosures on

Third, the severe housing downturn and surging foreclosures is weighing very heavily on the broader economy which may very well experience a recession in 2008 as a result. The stunning decline in housing activity and prices when combined with rising gasoline prices are crimping consumer spending, and the job market appears increasingly weak as it struggles with layoffs in housing-related industries. Regional economies such as California, Florida, Nevada, much of the Midwest, and parts of the Northeast, together accounting for close to one-half of the nation's GDP, are in my judgment already in or very near recession.

The unraveling of the housing and mortgage markets continues to undermine the fragile global financial system. Estimates of the mortgage losses global investors will eventually have to bear range as high as $500 billion.[4] The losses publicly recognized by financial institutions to date amount to no more than $150 billion. Losses on construction and land development loans made by the banking system to homebuilders are sure to increase measurably in coming quarters and the credit problems on other consumer loans are rising rapidly, particularly in those parts of the country in recession due to the housing downturn. These stresses are also exposing other weak spots in the financial system, including the monoline insurance industry and the credit default swap market. Given the opacity of the global financial system, it is unclear who are at most risk, and as such players in credit and equity markets remain on edge; unwilling to extend credit to each other. The availability of credit has been impaired and the cost of capital

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property values, see "There Goes the Neighborhood: The Effect of Single Family Mortgage Foreclosures on Property Values," Woodstock Institute, June 2005. http://www.woodstockinst.org/content/view/104/47/.

[4] See "Leveraged Losses: Why Mortgage Defaults Matter," Jan Hatzius, Goldman Sachs US Economic Research, November 15, 2007. "A Macro Look at Subprime Losses, ARMs and Convexity Hedging," Alec Crawford, RBS Greenwich Capital, November 2007.

has risen for nearly everyone, good credits and bad, and the negative economic repercussions are mounting.

The housing downturn is also undermining consumer spending. Even a modest pull-back by consumers will push the economy into recession, as such spending accounts for 70% of the nation's GDP. The odds of such a retrenchment are high given that the saving rate of the one-third of households who are homeowners and have borrowed against their homes in recent years is an estimated negative 10%. If this group, which also accounts for about one-third of all consumer spending, simply matches its spending to its income in the next couple of quarters, the negative impact on overall consumer spending will be substantial.

Fourth, while policymakers' efforts to date in response to the mounting problems in the housing and mortgage markets and broader economy are helpful, they may very well prove inadequate. Since this past summer, the Federal Reserve Board has aggressively lowered the federal funds rate target, and the administration and Congress are quickly working towards a substantive fiscal stimulus package. Policymakers are also working to shore up the housing and mortgage markets in several ways, most notable including increasing the GSEs' mortgage loan caps and the Treasury Department's effort through the Hope Now alliance to facilitate mortgage loan modifications and the establishment of mortgage repayment plans for struggling homeowners. Recent studies conducted by the Mortgage Bankers Association and Moody's Investors Service based on information provided by mortgage loan servicers through last fall indicate that hard-pressed homeowners are receiving some increased relief.[6] The Moody's study found that 3.5% of subprime ARM loans that reset in the first eight months of 2008 had been modified. This is up from only 1% in an earlier survey conducted by Moody's.[7]

Despite these improvements, given the still substantial impediments to loan modification efforts they are unlikely to increase sufficiently to forestall an unprecedented number of foreclosures through the remainder of this decade with the consequent negative repercussions for the broader economy. Some tax, accounting and legal hurdles appear to have been overcome, but large differences in the incentives of first and second mortgage lien holders and the various investors in mortgage securities are proving to be daunting. While the total economic benefit of forestalling foreclosure is significant, these benefits do not accrue to all of the parties involved in determining whether to proceed with a loan modification. Given the overwhelming number of foreclosures, loan servicers are also having difficulty appropriately staffing their modification efforts. Servicers are being asked to also act like a mortgage originator, which many are ill-equipped to do. Moreover, loan servicers remain nervous about being sued by investors for not adhering to contracts that bar or limit loan modification. It is also important to consider that for loan modifications to occur under the Treasury plan, many borrowers will have to produce more financial information than they did when they obtained the original loan. More than half of subprime loans in 2006, for example, were so-called 'stated-income' loans, for which borrowers were not required to produce a W-2 or tax return to prove their income. They may be reluctant or unable to do so now.

[6] See "An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and Other Loss Mitigation Activities in the Third Quarter of 2007," Mortgage Bankers Association, January 2008. http://www.mortgagebankers.org/files/News/InternalResource/59454_LoanModificationsSurvey.pdf and "U.S. Subprime Market Update: November 2007," Fricke and Drucker, December 17, 2007.

[7] See "Moody's Subprime Mortgage Servicer Survey on Loan Modifications," Moody's Investor Service, September 21, 2007. http://americansecuritization.com/uploadedFiles/Moodys_subprime_loanmod.pdf.

There are thus a number of significant impediments to the effective implementation of the Treasury plan via Hope Now, suggesting that at best an estimated 250,000 borrowers will actually benefit from loan modifications. Thus, while the Hope Now effort is laudable, it should not forestall passage of legislation such as HR 3609 to provide hard-pressed homeowners facing foreclosure more protection in a Chapter 13 bankruptcy. If Hope Now is successful in helping many borrowers, then these borrowers would not avail themselves of the opportunity to avoid foreclosure in Chapter 13 provided by this legislation. However, if Hope Now is not sufficiently successful, which may very well be the case, then this legislation will prove invaluable.

Fifth, this legislation, which would give bankruptcy judges the authority in a Chapter 13 to modify mortgages by treating them as secured only up to the market value of the property, will significantly reduce the number of foreclosures. An estimated over one-fourth of homeowners likely to lose their homes between now and the end of the decade, equal to an estimated 570,000 homeowners, would benefit from this legislation. This calculation is based on the number of homeowners who face a first payment reset through the end of the decade that would meet the means test required in a Chapter 13 and are still current on their mortgage loans. This would be very helpful in reducing the pressure on housing and mortgage markets and will measurably reduce the odds of recession next year. Note that in order to limit any potential abuses in this Chapter 13 modification process, Congress should provide firm guidelines to the bankruptcy courts, such as providing a formula for determining the term to maturity, the interest rate, and the property's market value.

Sixth, this legislation will not significantly raise the cost of mortgage credit, disrupt secondary markets, or lead to substantial abuses by borrowers. Given that the total cost of foreclosure to lenders is much greater than that associated with a Chapter 13 bankruptcy, there is no reason to believe that the cost of mortgage credit across all mortgage loan products should rise. Simply consider the substantial costs associated with navigating through fifty different state foreclosure processes in contrast to one well-defined bankruptcy proceeding. Indeed, the cost of mortgage credit to prime borrowers may decline. The cost of second mortgage loans, such as piggy-back seconds, could rise, as they are likely to suffer most in bankruptcy, but such lending has played a clear contributing role in the current credit problems. It is also important to note that the legislation currently being considered here today applies to existing first mortgage loans, and thus should have no bearing on interest rates on loans originated going forward.

There is also no evidence that secondary mortgage markets will be materially impacted after a period of adjustment, as other consumer loans which already have similar protection in Chapter 13 have well-functioning secondary markets. Moreover, the non-conforming residential mortgage securities market has already effectively shut down in the wake of the ongoing financial shock, and will only revive after there are major changes to the securitization process. The changes proposed in this legislation are immaterial by comparison.

It is very unlikely that abuses by mortgage borrowers will increase as a result of this legislation given that a workout in Chapter 13 is a very financially painful process. Indeed, the number of bankruptcy filings has remained surprisingly low since the late

2005 bankruptcy reform, likely reflecting the now much higher costs to borrowers in a Chapter 13 proceeding. Short-term housing investors or flippers, those who borrowed heavily looking to make a quick profit in the housing boom, would certainly not consider Chapter 13 as a viable solution to their financial problems.

The housing market downturn continues to intensify and mortgage foreclosures are surging. A self-reinforcing negative dynamic of mortgage foreclosures begetting house price declines begetting more foreclosures is underway in many neighborhoods across the country. The odds of a full-blown recession are very high. There is no more efficacious way to short-circuit this developing cycle and forestall a severe recession than passing this legislation.