Statement of

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Hearing before the Oversight and Government Reform Committee – June 24, 2010

Submitted testimony by Edward Pinto, real estate financial services consultant and Fannie Mae's chief credit officer 1987-1989.

Chairman Towns and Ranking Member Issa, thank you for the opportunity to testify today. I am an expert in credit risk methodologies and loan performance metrics. I was Fannie Mae's chief credit officer from 1987 to 1989. In the mid-1980s I was responsible for Fannie's single and multi-family loan marketing, including management of its affordable housing programs.

My purpose in testifying today is to review the overall effectiveness of HAMP.

In evaluating HAMP, it is useful to recall its original goals:

> **"The Home Affordable Modification Program is designed to help as many as <u>3 to 4 million financially struggling homeowners avoid foreclosure by modifying loans to a level that is affordable for borrowers now and sustainable over the long term</u>. The program provides <u>clear and consistent loan modification guidelines that the entire mortgage industry can use</u> ….**
>
> **<u>After determining a borrower's eligibility</u>, a servicer will take a series of steps to adjust the monthly mortgage payment to 31% of a borrower's total pretax monthly income."[1] (Emphasis added)**

Let us start with the goal to avoid 3-4 million foreclosures with sustainable modifications. Moody's Economy.com "expects HAMP restructurings to help 1 million to 1.5 million homeowners stay in their homes without a default."[2] I believe that even this greatly reduced total is overly optimistic. When I testified before the Domestic Policy Subcommittee of this Committee last February, I advised that the then current HAMP pipeline of some 3.4 million HAMP-eligible delinquent borrowers might help just 250,000 of these homeowners stay in their homes without default. As I will explain later on, it appears that my estimate is pretty close to the mark.

There is one fundamental reason for this projected short fall. Government initiatives dating back to the early- to mid-1990s mandated looser underwriting standards and resulted in trillions upon trillions of dollars of weak loans being originated, with Fannie and Freddie playing a leading role. This is best

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[1] HAMP website https://www.hmpadmin.com/portal/programs/hamp.html
[2] "Can HAMP Prevent 'Strategic Defaults"?, National Mortgage News, May 24, 2010

demonstrated by the policy initiative relating to reducing and eventually largely eliminating downpayments – a policy embodied in HUD's 1995 National Homeownership Strategy.[3] In 1990 only about 5% of home purchase loans had a downpayment of less than 5% and virtually all were insured by FHA or VA. By 2006 the National Association of Realtors reported for first time home buyers "nearly half of [such buyers] nationwide put down no money."[4] It is this legacy of weak loans that has made qualifying at-risk loans for modifications so difficult. Consider that in both 2007, when the unemployment rate was 4.6% and in 2009, when the unemployment rate had doubled to 9.3%[5], 72% and 75% respectively of Fannie's loan losses related to the same categories of weak loans.[6] While high unemployment has exacerbated the foreclosure situation, the loans going bad are still largely those that were risky to begin with.

A high re-default rate will also work to keep HAMP's total of successful modifications low. While some project a permanent modification re-default rate of over 50%, I expect a lower, but still high rate of 40%. Why so high? First, most permanent modifications are on loans with mortgage balances well in excess of current home values. Second, borrowers obtaining a permanent modification through May 2010 had a median total debt-to-income ratio of 64%.[7] A total debt-to-income ratio of 40% would be considered high on a loan not at risk. This leaves little money for food, clothing, taxes, and other expenses. As a result these borrowers are a worn out furnace or roof replacement away from re-default.

In December 2008 I testified before this Committee and warned that any modification plan must target the right group of homeowners, but equally important, participants must be willing and able to carry a fixed-rate, reasonably priced mortgage.

Back in February I warned the Domestic Policy Subcommittee of this Committee that:

> **"[t]he press release announcing the January 2010 HAMP report attempted to paint a rosy gloss on the program's meager accomplishments. In a statement that strains credulity, it noted '[t]he program is on pace to meet its overall program goal of providing 3-4 million homeowners the opportunity to stay in**

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[3] "Lending institutions, secondary market investors, mortgage insurers, and other members of the partnership should work collaboratively to reduce homebuyer downpayment requirements." HUD's 1995 "National Homeownership Strategy", http://web.archive.org/web/20010106203500/www.huduser.org/publications/affhsg/homeown/chap1.html
[4] USA Today, "First rung on property ladder gets harder to reach", July 17, 2007 http://www.usatoday.com/money/economy/housing/2007-07-16-first-time-buyers_N.htm
[5] Bureau of Labor Statistics, http://data.bls.gov/PDQ/servlet/SurveyOutputServlet?series_id=LNS14000000
[6] Fannie's Q1:10 Credit Supplement, p. 6, http://www.fanniemae.com/ir/pdf/sec/2010/q1credit_summary.pdf
[7] May 2010 HAMP Report

> **their homes.' The truth is HAMP has been a spectacular failure when measured against the original goal of helping 3-4 million homeowners avoid foreclosure."**

I also noted that the then current HAMP pipeline would likely yield only 250,000 homeowners who would ultimately avoid foreclosure under HAMP – only about 6%-8% of the original goal. It now looks like my projection will be pretty close to the mark. HAMP activity has slowed markedly, with the number of new monthly trial modifications declining by two-thirds between December 2009 and May, 2010. The number of new permanent modifications in May 2010 was 30% below the April 2010 count. As of May 31, 2010 there were 340,000 active permanent modifications.[8] Assuming a 40% re-default rate, only 200,000 of these permanent modifications will likely be successful over the long-term. There are another 468,000 active trial modifications. Of these, perhaps only 75,000 will become successful long-term permanent modifications. Discounting all the spin, a slowing HAMP pipeline will yield about 275,000 successful long-term permanent modifications, with perhaps another 100,000 successes resulting from future trial modifications.

Today, I reiterate my warning about Treasury's propensity for applying a rosy gloss. Just this past Monday, the May HAMP report stated:

> **"Most homeowners in canceled trials became current on mortgage payments or enter an alternative modification."**

It turns out that of the 194,000 canceled trial modifications with a disposition path, only 19,000 or 9.8% were current. Not quite as reassuring as Treasury's statement. It turns out that some 95,000 or about 50% are in "alternative modification", but more on that later.

The Treasury Department also promised "clear and consistent loan modification guidelines that the entire mortgage industry can use." There are only two words to describe HAMP's guidelines: numbing complexity. At last count HAMP had 800 requirements and servicers are expected to certify compliance.[9] With ever changing regulations, a constant need to re-evaluate past decisions in light of new regulations, and multiple appeals, it is no wonder that the HAMP pipeline became clogged through no substantial fault of servicers.[10]

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[8] Id.

[9] "Servicers Sweat HAMP Certification for 800 Separate Requirements", May 24, 2010, National Mortgage News

[10] The clogged pipeline problem dates back to a desire by Treasury to post big numbers early on. To achieve this, the entirely new concept of a trial modification was introduced. Borrowers were allowed to enter a trial without qualifying on the basis of income. No doc loans were replaced with no doc modifications. This wasn't fair to those borrowers who had no chance

The GAO observed:[11]

> **"Servicers faced challenges implementing HAMP because of the number of changes to the program, some of which have required servicers to readjust their business practices, update their systems, and retrain staff."**

Treasury also failed in its promise that a borrower's eligibility would be determined upfront. As was recently observed by James Hagerty of The Wall Street Journal:[12]

> **"Eager for quick results, the Obama administration last year prodded banks to start people on trials without first obtaining documents proving they were eligible. That has led to many crushed hopes."**
>
> **"While awaiting answers, some borrowers keep making payments, exhausting their savings in what may be a futile effort to save their homes. They also incur fees from the banks and delay taking action that might give them a fresh start in a more affordable home."**

Turning to "alternative modifications", we are at risk of repeating the same policy mistake that got us into this mess. Just as the government's calls for looser lending standards and HUD's "best practices' policies made it difficult to turn down unqualified borrowers for a loan, HAMP and its off-spring are evolving into programs aimed at approving a modification no matter the financial cost or sustainability. In March, Fannie and Freddie announced their "alternative modification" programs. Many of those homeowners who entered into a trial mod before March 1, 2010 and were unable to qualify for a permanent modification may be now considered for an alternative modification. On properties with a current LTV >80%, monthly mortgage payments may be reduced to below 20% of a borrower's income and the net present value test is no longer a constraint. Once again servicers are being required to re-evaluate the same borrower for the umpteenth time, but now the message is approve no matter the cost. This appears to be an attempt to paper over the problems resulting from HAMP's clogged pipeline.

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of qualifying. They were left in a no man's land and many will be worse off than if they had been given a quick no and encouraged to find alternative housing. This design flaw caused the HAMP pipeline to become hopelessly clogged, leading to a series of blame and shame attacks on servicers. While servicers have certainly made mistakes, the lion's share of the blame falls on Treasury for poor program design. It has taken until April and May 2010 to finally start canceling these inappropriate trial modifications in sizable numbers.

[11] http://www.gao.gov/products/GAO-10-556T

[12] WSJ, "Loan Aid Leaves Some Worse Off", May 18, 2010, http://online.wsj.com/article/SB10001424052748703315404575250463403570640.html

Treasury's many missteps with HAMP have had other repercussions.

It has encouraged strategic defaults - homeowners are willing to default when the value of a mortgage exceeds the value of their house, even if they can afford to pay their mortgage.

Amherst Securities's research found that HAMP encourages such defaults because:[13]

> **"[T]hey can live in their house rent free during the time it takes to establish if they qualify for a HAMP mod. And if they qualify, they can stay in the program for at least 3 months, even if they do not make a single payment."**

Researchers at the University of Chicago and Northwestern University found that:[14]

> **"[In Quarter 1, 2010], more homeowners voluntarily defaulted on their mortgages and chose to walk away from their homes than the total number of mortgages permanently modified to date under the Administration's year-old Home Affordable Modification Program (HAMP). The percentage of foreclosures that were perceived to be strategic was 31 percent in March 2010, [up dramatically] compared to 22 percent in March 2009 [when HAMP started]…. With more and more homeowners believing that lenders are failing to pursue those who default on their mortgages, there is a risk that a growing number of homeowners will walk away from their homes even if they can afford monthly payments."**

HAMP's flawed design and implementation along with Treasury's early efforts to "shame and blame" the mortgage servicers promoted strategic defaults, as many borrowers came to expect a modification and blamed their servicer for not getting one.

HAMP has also slowed down foreclosure processes, pushing the level of heightened foreclosure activity out to 2013 or 2014 and likely extending the period for the market to correction.

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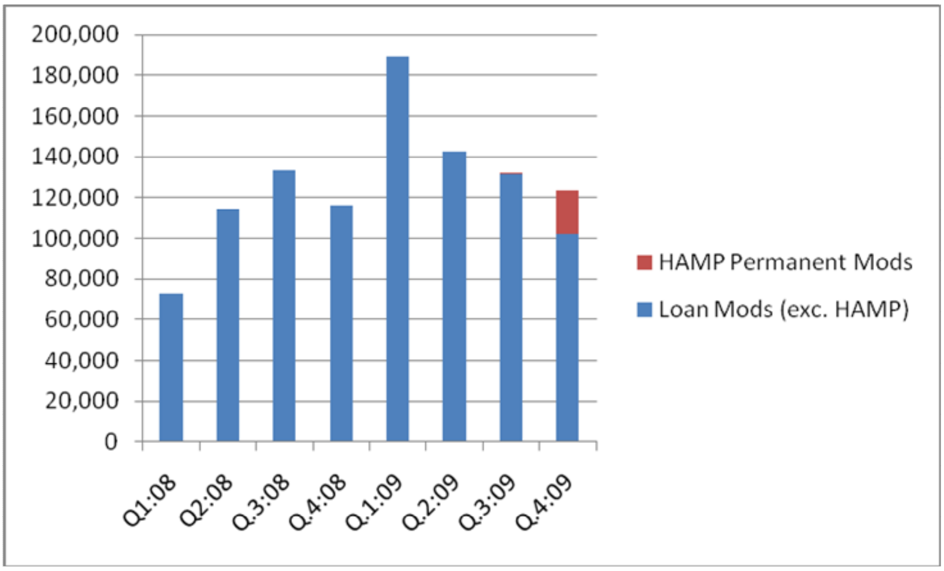
[13] "Studies Show HAMP Promotes Strategic Default on Mortgages", http://www.housingwire.com/2010/03/26/studies-show-hamp-promotes-strategic-default-on-mortgages

[14] "Strategic Defaults Outpace HAMP Modifications", May 4, 2010 http://www.upi.com/Real-Estate/2010/05/04/Strategic-Defaults-Outpace-HAMP-Modifications/8591272984515/

HAMP greatest shortcoming was that it derailed burgeoning private sector efforts to effectively modify loans. Let's look at the facts as documented in the OCC/OTS Mortgage Metrics Report (MMR).[15] Chart 1 demonstrates that private sector had been rapidly ramping up its modification efforts in 2008 and early 2009. Chart 2 demonstrates that these private efforts were achieving success as evidenced by rapidly decreasing re-default rates. Re-default rates after three months dropped by more than half from 35.1% in Q.4:08 to 14.7% in Q.3:09. This success was <u>before</u> HAMP permanent modifications had any impact.

HAMP began in Q.2:2009 and as can be seen from Chart 1, it reversed the upward trend in the numbers of modifications. HAMP hopelessly tied the modification process up in knots. In Q.1:2009 the MMR reported a total of 189,000 loan modifications, well more than double the level in Q1:08. This compares to only 123,000 modifications (including permanent HAMP modifications) completed during Q.4:2009 report (the most recent MMR). The MMR report for Q.1:10 is expected in a few days. It will likely show that the combined total of HAMP and non-HAMP modifications will finally, after a year, exceed the total from Q.1:09.

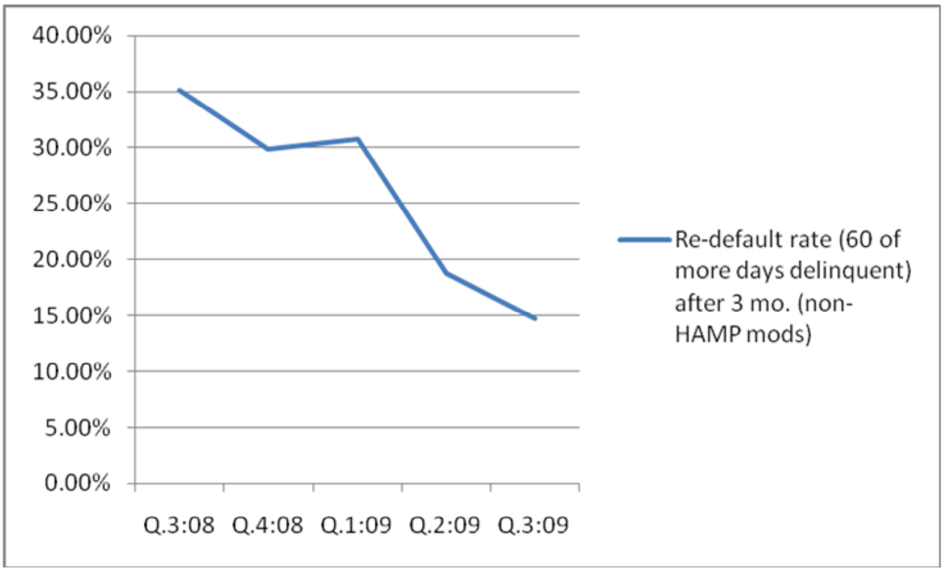
Chart 1 – HAMP"s Impact Private Sector's Modification Efforts:



Source: Mortgage Metrics Report

[15] MMR covers more than 64% of all first lien mortgages. MMRs found at:
http://www.occ.treas.gov/ftp/release/2008-150a.pdf
http://www.occ.treas.gov/mortgage_report/MortgageMetrics.htm

Chart 2 - Re-dafault rate (60 days or more delinquent) after 3 mo. (non-HAMP Mods):



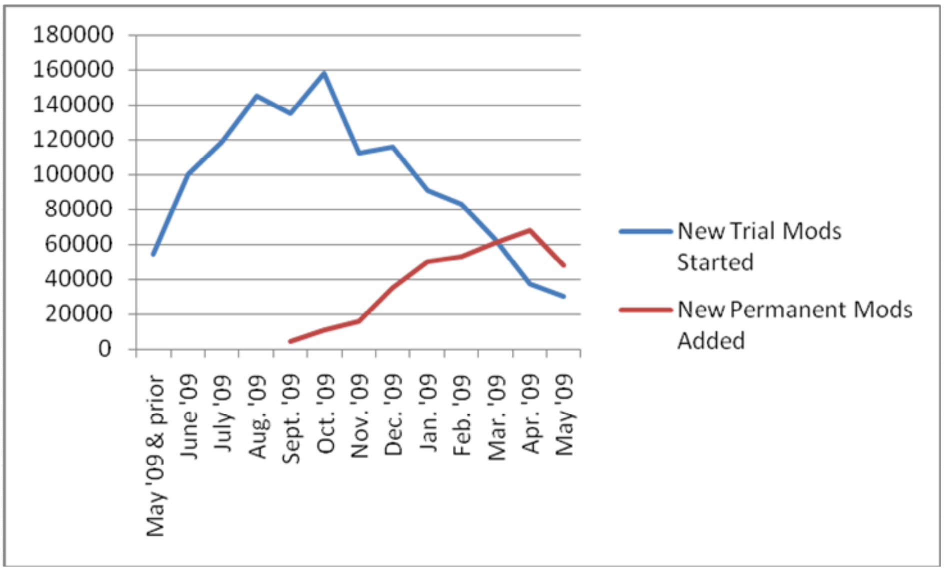
Source: Mortgage Metrics Report

Poorly designed federal modification programs merely "kick the can" down the road and ultimately cost more money. The goal of any modification program must be to create sustainable loans that preserve and build up homeowner equity.

This Committee should be asking the Treasury Department: where are the modifications that, but for HAMP, the private sector was on track to produce?

This committee and the American people deserve an honest assessment as to HAMP's future. As Chart 3 demonstrates, HAMP is rapidly winding down, with little to show for in the way of long-term results compared to its promises. Perhaps this is for the best, as it may allow the private sector to proceed unhampered and regain lost momentum.

Chart 3 – New Trial and Permanent Modifications Started Under HAMP



Source: May 2010 HAMP Report

Thank you and I would be happy to take questions at the appropriate time.