Testimony of

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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 over two years ago, and since then home sales have fallen by over 30%, housing starts by 40%, and house prices by 7%. Over half 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 into 2009 as a record amount of unsold housing inventory continues to mount given the impact of the recent subprime financial shock and its impact on the mortgage securities market and thus mortgage lenders. There is now a broad consensus that national house prices will fall by between 10% and 15% from their peak to their eventual trough. Even this disconcerting outlook assumes that the broader economy will avoid recession and that the Federal Reserve will continue to ease monetary policy.

Second, residential mortgage loan defaults and foreclosures are surging and without 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 most recently a weakening job market are conspiring to create the current unprecedented mortgage credit problems. Even if mortgage loan modification efforts soon measurably increase, I expect approximately 2.8 million mortgage loan defaults (the first step in the foreclosure process) in 2008 and 2009. Of these, 1.9 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%.

Third, there is a substantial risk that the housing downturn and surging foreclosures will result in a national economic recession. 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 and much of the industrial Midwest, together accounting for well over one-fourth of the nation's GDP, are in my judgment already in recession.

The turmoil in the housing and mortgage markets also threatens to further upend the fragile global financial system, with very clear negative implications for the U.S. economy. Estimates of the mortgage losses global investors will eventually have to bear range as high as $500 billion. The losses recognized by financial institutions to date amount to no more than $75 billion. If the U.S. economy does slide into recession, then of course house prices will decline and foreclosures will rise to an even more serious degree.

Fourth, without a quick policy response, mortgage loan modification efforts are unlikely to increase enough to forestall a surge in foreclosures. A recent Moody's survey of loan servicers found that very little modification had been done, at least through this past summer. This highlights the substantial impediments to modification efforts. 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. Given the overwhelming number of foreclosures, loan servicers are also having difficulty appropriately staffing their modification efforts. 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.

A recent initiative by the Treasury Department and the nation's largest lenders to freeze interest rates on resetting subprime ARM loans is laudable, but should not forestall passage of Senator Durbin's legislation, the Helping Families Save Their Homes in Bankruptcy Act. If the Treasury plan 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. If, however, Treasury's efforts are unsuccessful, which may very well be the case, then this legislation would prove invaluable.

Fifth, Senator Durbin's 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.

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 is intensifying 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 recession than passing this legislation.

1. See "Aftershock: Housing in the Wake of the Mortgage Meltdown," Moody's Economy.com, December 2007.

2. See "The Value of Foreclosed Property," Anthony Pennigton-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 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/.

3. 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.

4. 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.