

Testimony of

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TESTIMONY OF CHRISTOPHER J. MAYER BEFORE THE COMMITTEE ON THE JUDICIARY UNITED STATES  
SENATE HEARING: HELPING FAMILIES SAVE THEIR HOMES: THE ROLE OF BANKRUPTCY LAW NOVEMBER  
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Good morning Chairman Leahy, Ranking Member Specter, Ac and Members of the Committee. Thank you for inviting me to speak today. My name is Christopher J. Mayer. I am the Paul Milstein Professor of Real Estate and Senior Vice Dean at Columbia Business School. I have spent the last 16 years studying housing markets and credit while working at the Federal Reserve Bank of Boston and serving on the faculties of Columbia Business School, the University of Michigan Business School, and the Wharton School of the University of Pennsylvania.

Preventing foreclosures is an important goal because of the human suffering from homeowners losing their homes and the spillover effect on local communities and governments. However, it is crucial to consider the broader context of the housing and foreclosure crisis. Reducing foreclosures through allowing judicial "strip-downs" comes with many risks, including likely increases in the future cost of borrowing (or reductions in the amount available to borrow) as well as the possibilities of many millions of additional bankruptcy filings and of substantially slowing down the recovery of the housing and mortgage markets. These negative consequences would impact nearly all Americans. In addition, in my view, there are quicker and more substantial policies available that could substantially reduce foreclosures by reducing the rate of house price declines as well as benefiting tens of millions of homeowners and potential homeowners. These policies would focus on reinvigorating the mortgage market and helping bridge the gap between house prices and mortgage values. My comments on judicial strip downs as well as suggestions for alternative policies are summarized below.

#### 1) Risks and Problems with Judicial "Strip Downs" and existing legislation

a. While few studies exist, evidence suggests "strip-downs" or delays in foreclosures reduce the amount of available mortgage borrowing and may also increase mortgage rates.

Economists often point out that there is no such thing as a free lunch. Two or slower foreclosures reduce the amount of borrowing available. Karen Pence shows that loans sizes are 3 to 7 percent

smaller in defaulter-friendly states. 1 Research by Adam Levitin and Joshua Goodman shows that loan-to-value ratios are almost 2.8 percent lower for the borrowers at the 80th percentile of the loan-to-value distribution in their preferred specification within 6 months of allowing strip-downs (Table 4a).<sup>2</sup> As well, the authors find increased mortgage rates at or below the median borrowing rate of between 0.15 and 0.27 percent within 6 months after allowing strip-downs (Table 2a). In addition, the Levitin and Goodman evidence might well underestimate the effect of allowing strip-downs on credit availability. Uncertainty across judicial districts at the time of those changes in federal judicial rulings suggests that lenders must have factored in some risk that the courts or legislators might eventually clarify the law to allow strip-downs in all states. The Pence results are based on more stable differences in state laws and find larger impacts of reduced creditor rights on mortgage credit availability.

Even beyond existing studies, common sense suggests lenders would be wary of lending in an environment in which rules change after the fact and creditor rights to collect on their collateral are reduced.

b. The current legislation provides disincentives to borrowers to negotiate under most existing private and FDIC-sponsored loan modification programs, likely delaying resolution of the housing crisis.<sup>i</sup>

The recently announced FDIC program to modify Indy Mac mortgages provides a possible benchmark for other private lenders and servicers to roll-out large-scale programs to quickly modify millions of troubled loans. The FDIC/Indy Mac program provides for reductions in both interest rates and forbearance on principal payments.<sup>4</sup> While there are some problems with the incentives in the FDIC/Indy Mac program that encourage borrowers to miss payments in order to qualify for a loan modification, this program can be rolled-out in a large enough scale to make a significant dent in foreclosures over a short period of time and thus has significant benefits. The recently announced private effort by Jp Morgan/Chase uses a similar strategy of loan forbearance. Many of the Bank of America and Citigroup modifications to subprime loans involve interest rate reductions rather than principal reductions. Fannie Mae and Freddie Mac have rolled out their own programs.

Borrowers have little incentive to accept an offer from a lender of interest rate reductions or forbearance, when they can go to court and have a judge strip-down their principal balance, leading to an eventual permanent reduction in the amount of money they owe on their mortgage. When house prices rise, as they eventually will, strip-downs eliminate the possibility that a lender will ever recover its losses on borrowing. Thus borrowers have incentives to hold out for a better deal than they are likely to be currently offered, potentially delaying the resolution of housing problems for years. It will require time for the courts to examine all the issues with various types of complex mortgages and to develop precedents and operating procedures for handling millions of bankruptcies. Evidence from the Japanese recession of the 1990s shows that delays in resolution are a poor way of dealing with credit problems.

Private lenders do not face legal restrictions with resolving their own loans, as servicers do, so they could choose write downs if they thought that write-downs were a more profitable way of resolving credit problems relative to forbearance. Thus a program of forcing strip-downs must surely lower these lenders' recoveries, leading them to raise rates on future loans given the likelihood that judicial strip-downs might become the law for future loans as well.

Private lenders are now moving ahead with much more aggressive workout programs. These programs should be given time to work. To the extent that legal liabilities for servicers are delaying workouts for some pools, legislators might consider more explicit protections for servicers who attempt to maximize recoveries through applying the same loan modification program to their pools with third-party servicing as with their own pools. However, as described below, I believe that a program to share losses and move as many mortgages as possible out of troubled securitizations is the best policy.

c. The existing legislation is written quite broadly relative to the number of

One of the largest tragedies of the current subprime crisis is the fact that some borrowers were misled into getting mortgages that they did not understand and would eventually not be able to afford. Research by economists Brian Bucks and Karen Pence of the Federal Reserve Board shows that the most difficult to understand provisions of mortgages included the margin on adjustable rate mortgages and the possibility of future rate increases.<sup>5</sup>

The existing legislation includes all subprime loans, both fixed- and adjustable-rate loans. Borrowers with fixed-rate mortgages would have surely received loans that they understood. While the payment-to-income ratios were high on some of these subprime loans, borrowers likely understood the benefits of making regular payments in order to allow them to build up their credit and refinance into a lower rate mortgage. As I discuss below, the most appropriate fix for these borrowers is to repair the mortgage market so responsible subprime borrowers who have made all their payments can refinance into a lower rate, conforming mortgage. Allowing fixed-rate borrowers with simple mortgages to strip-down their balance is unfair to the many other borrowers who took on mortgages and bought houses they could better afford.

As well, many adjustable-rate borrowers may now be in default even before they have faced an appreciable rate increase. If the major problem is the excesses associated with subprime lending, I would recommend that the legislation much more narrowly focus on two particular products that encompass the most toxic loans: i) subprime 2/28 or 3/27 mortgages-loans that are fixed for 2 or 3 years, and then adjust to a higher rate beyond the teaser rate; and ii) so-called "option ARMs" that allow mortgage balances to negatively amortize. To further limit a possible spurt of bankruptcy filings and to encourage quicker workouts, lenders should be able to obtain a "safe harbor" from bankruptcy filing by modifying the loan to ensure that rates on subprime 2/28 or 3/27 mortgages will not rise above the initial rate. The option-ARMs are more difficult to resolve, but lenders should be able to obtain a safe

harbor by limiting the extent of negative amortization by writing down mortgage balances. It was for the group of option ARM borrowers that Bank of America agreed to forgive some negative amortization in the Countrywide settlement.

Limiting the legislation to a very specific group of likely misled borrowers allows for a much quicker resolution of existing cases, as well as sends a message to lenders that the legislated strip-downs are quite limited and thus might mitigate future mortgage rate increases from the legislation. After all, it is quite unlikely that lenders will again issue such toxic mortgage products in any scale. By contrast, applying strip-downs to fixed-rate mortgages sold to riskier borrowers sends a strong message to future lenders that they should be careful about lending to risky borrowers. This would likely appreciably reduce lending for exactly the type of mortgage loans for the riskiest borrowers that we would like to encourage in the future and set back much of the recent progress in providing funding to disadvantaged borrowers.

I should be clear: I believe it would be quite problematic to allow the judicial strip-downs proposed in this legislation as they inherently change the terms of existing lending contracts and inhibit the possibility of quicker large-scale resolutions of problem loans. However, limiting the classes of covered borrowers would mitigate the damage and there are some compelling arguments in favor of adjusting the terms of the most misleading and toxic contracts.

2)"Fix the Mortgage Market": The Hubbard-Mayer proposal for putting a floor on house price declines, cleaning up household balance sheets and preventing foreclosures by refinancing millions of homeowners into stable 30-year fixed rate mortgages<sup>6</sup>

a. The Problem: Higher mortgage rates lead to lower house prices

Even as the federal government has taken conservatorship of Fannie Mae and Freddie Mac, the spread between the interest rate on the average 30-year conforming mortgage and the 10-year Treasury bond has widened enormously. In fact, while the yield on the 10-year Treasury bond has fallen by nearly 1.5 percent in the past 2 years, the average rate on a conforming mortgage has fallen by about 0.5 percent. The increase in mortgage spreads has had catastrophic consequences for housing affordability and will surely drive house prices down well below what their fundamental value would be with a normally functioning mortgage market.

The impact of this additional increase in the mortgage spread is quite large. Our calculations suggest that malfunctioning mortgage markets have reduced housing affordability by between 10 to 17 percent. These computations suggest an appreciable drop in demand associated with higher mortgage rates that could push house prices down far beyond where they should fall based on fundamentals. The

combination of a deteriorating economy and malfunctioning mortgage market are leading house prices to spiral downward.

b. Higher mortgage rates and lower house prices lead to more foreclosures

Research at the Federal Reserve Bank of Boston and the Federal Reserve Board of Governors confirms that falling house prices are a major factor contributing to the rise in mortgage default rates.<sup>7</sup> In my mind, the single most effective policy to reduce foreclosures would be to help put a floor on declining house prices and improve the mortgage market.

Some have argued that we are in a new downward spiral in which declining house prices cause greater foreclosures, which then lead to even further house price declines. Research has not clearly demonstrated that foreclosures really cause house prices to fall. Certainly neighborhoods that have a cluster of foreclosures are likely to see house prices fall in the short-run, but the best policy might be to help local communities fight crime and other negative externalities if it is not possible or efficient to prevent all foreclosures.

Finally, in addition to falling house prices, the mortgage market meltdown itself has likely led to additional foreclosures. Subprime borrowers who could otherwise afford a refinanced mortgage at 5.25 percent might not be able to afford a mortgage on the same home at the current 6.25 percent rate.

c. Solution: Lower mortgage rates and work out negative equity

We believe the appropriate course for policy is to re-establish "normal" lending terms for housing finance, while offering tools to resolve the millions of mortgages with negative homeowners' equity, preventing unnecessary foreclosures.<sup>8</sup> The appropriate mortgage rate would be about 1.6 percent above the 10-year Treasury, which would lead current mortgage rates to be about 5.25 percent.

A second part of our plan is to create a modern equivalent of the Home Owners Loan Corporation. The modern HOLC would initially offer to help homeowners with negative equity refinance into a stable 30-year fixed rate mortgage with a 95 percent loan-to-value ratio by helping to absorb negative equity that is currently freezing credit and housing markets. It could offer to owners and servicers the opportunity to split the losses evenly on refinancing a mortgage with the new agency. Servicers or lenders would have to agree to accept these refinancings on all mortgages or on none at all to avoid cherry-picking. In return for the government portion of the write-down, which would be paid in cash, the HOLC would take an equity position in the house so that the taxpayer-funded agency profits when the housing market turns around. The cash cost of this program would be \$121 billion per year, but this would be partially offset by home equity gains as house prices stabilize and eventually start to rise.

We see two immediate beneficiaries of lower rates for 30-year fixed rate mortgages: existing borrowers currently in adjustable rate mortgages with higher rates and complicated step-up provisions and new first-time home buyers. Getting more homeowners into easily understandable mortgages would surely provide large benefits by eliminating more complicated mortgage products that many consumers do not understand and that put these consumers at risk of large payment shocks. In addition, lower mortgage rates make housing more affordable. Moreover, a substantial intervention that benefits homeowners and the housing market will surely raise the confidence of buyers that an end to the downward spiral of house prices may be in sight.

d. Lower mortgage rates provide a stimulus of \$118 billion per year

Allowing mortgage refinancing as we have described above would reduce mortgage payments for almost 20 million homeowners whose mortgage rates are currently 5.75 percent or higher and meet our other criteria.<sup>9</sup> The typical borrower would reduce his or her principal and interest payments by about \$350 dollars, a total reduction in mortgage interest payments of nearly \$55 billion per year.

At the low end of our estimates, improved mortgage market operations would reduce house price declines by 10 percent. If we assume a relatively low consumption would rise by \$63 billion relative to what would otherwise have occurred.

The current mortgage meltdown and housing crisis has led to serious repercussions to the economy and to our financial system. Reducing foreclosures is an essential part of the recovery process. Rather than using the bankruptcy courts, which might take years and lead to higher lending costs in the future, policymakers should consider focusing on the mortgage market. Helping consumers to refinance into new mortgages with lower rates and helping to address the negative equity problem will reduce foreclosures, help clean up consumer balance sheets, and provide an annual \$118 billion stimulus. Economists believe that consumers are much more likely to spend permanent reductions in expenses than one-time stimulus funds. In addition, a well-publicized program to reduce mortgage rates helps instill confidence and improve affordability for potential new home buyers, who must eventually occupy the more than 2 million vacant houses. Finally, taxpayers have strong incentives to protect their nearly \$6 trillion in mortgages and mortgage guarantees that now sit on the federal balance sheet. Without appropriate and prompt policy action, the problems in the housing market will just get worse with appreciable consequences for all Americans.

1 Pence, Karen M. 2006. "Foreclosing on Opportunity: State Laws and Mortgage Credit." Review of Economics and Statistics, 88:1,177-82.

2 Levitin, Adam J and Joshua Goodman. 2008. "The Effect of Bankruptcy Strip-Down on Mortgage Markets," Georgetown University Law Center, Business, Economics and Regulatory Policy Working Paper Series Research Paper No. 1087816.

3 See "Loan Modification Review" issued by RBS/Greenwich Capital on 11/14/2008 for a summary of the various loan modification programs.

4 Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

5 Bucks, Brian and Karen Pence. 2008. "Do borrowers know their mortgage terms?" *Journal of Urban Economics*, 64(2): 218-33.

6 More detail on the proposal is described in the paper "House Prices, Interest Rates, and the Mortgage Market Meltdown" by Christopher Mayer and R. Glenn Hubbard. The paper and an FAQ are available on the web at <http://www4.gsb.columbia.edu/real estate/research/mortgagemarket>.

7 See Foote, Chris, Kristopher Gerardi, and Paul S. Willen. 2008. "Negative Equity and Foreclosure: Theory and Evidence," *Journal of Urban Economics*, 64(2):234-245; Sherlund, Shane. 2008. "The Past, Present, and Future of Subprime Mortgages." Federal Reserve Board, November; Mayer, Christopher, Karen Pence, and Shane Sherlund. 2009. "The Rise in Mortgage Defaults," *Journal of Economic Perspectives*, forthcoming.

8 This argument was initially laid out in the opinion piece by R. Glenn Hubbard and Christopher Mayer entitled "First, Let's Stabilize House Prices," *Wall Street Journal*, October 2, 2008.

9 See Appendix 3 for detailed calculating and what the costs and benefits might be for other caps.