Testimony of Mark A. Calabria, Ph.D.
Director, Financial Regulation Studies, Cato Institute
Before the
House Committee on Oversight and Government Reform
On "Foreclosure Prevention: Is The Home Affordable Modification Program Preserving Homeownership?"
March 25, 2010

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Chairman Towns, Ranking Member Issa, and distinguished members of the Committee, I thank you for the invitation to appear at today's important hearing. I am Mark Calabria, Director of Financial Regulation Studies at the Cato Institute, a nonprofit, non-partisan public policy research institute located here in Washington. Before I begin my testimony, I would like to make clear that my comments are solely my own and do not represent any official policy positions of the Cato Institute. In addition, outside of my interest as a citizen and a taxpayer, I have no direct financial interest in the subject matter before the subcommittee today, nor do I represent any entities that do.

My testimony today will address two specific questions. The first is: why have the Obama and Bush Administration efforts, along with those of the mortgage industry, to reduce foreclosures had so little impact on the overall foreclosure numbers? This critique applies to the Home Affordable Modification Program as well as previous efforts, such as HOPE NOW.

The second question is: given what we know about why previous efforts have had such little impact, what are our policy options?

In answering both these questions, I rely on an extensive body of academic literature, the vast majority of which has been subjected to peer review, which has examined the determinates of mortgage delinquency and default. Foremost among this literature is a series of recent papers written by economists at the Federal Reserve Banks of Boston and Atlanta, in particular the work of Paul Willen, Christopher Foote and Kristopher Gerardi. My testimony owes a considerable intellectual debt to this research.

Why haven't previous efforts stemmed the foreclosure tide?

The short answer to why previous federal efforts to stem the current tide of foreclosures have largely failed is that such efforts have grossly misdiagnosed the causes of mortgage defaults. An implicit assumption behind former Treasury Secretary Paulson's HOPE NOW, FDIC Chair Sheila Bair's IndyMac model, and the Obama Administration's current foreclosure efforts is that the current wave of foreclosures is almost exclusively the result of predatory lending practices and "exploding" adjustable rate mortgages, where large payment shocks upon the rate re-set cause mortgage payment to become "unaffordable."

The simple truth is that the vast majority of mortgage defaults are being driven by the same factors that have always driven mortgage defaults: generally a negative equity position on the part of the homeowner coupled with a life event that results in a substantial shock to their income, most often a job loss or reduction in earnings. Until *both* of these components, negative equity and a negative income shock are addressed, foreclosures will remain at highly elevated levels.

Given that I am challenging the dominant narrative of the mortgage crisis, it is reasonable to ask for more than mere assertions. First, if payment shock alone were the dominate driver of defaults then we would observe most defaults occurring around the time of re-set, specifically just after the re-set. Yet this is not what has been observed. Analysis by several researchers has found that on loans with re-set features that have defaulted, the vast majority of defaults occurred long before the re-set. Of course some will argue that this is due to such loans being "unaffordable" from the time of origination. Yet according to statistical analysis done at the Boston Federal Reserve, the borrower's initial debt-to-income (DTI) had almost no predictive power in terms of forecasting subsequent default.

Additionally if payment shock was the driver of default, the fixed rate mortgages without any payment shocks would display default patterns significantly below that of adjustable rate mortgages. When one controls for owner equity and credit score, the differences in performance between these different mortgage products largely disappears. To further illustrate this point, consider that those mortgages generally considered among the "safest" – mortgages insured by the Federal Housing Administration (FHA), which are almost exclusively fixed rate with no-prepayment penalties and substantial borrower protections, perform, on an apples to apples basis, as badly as the subprime market in terms of delinquencies.

The important shared characteristic of FHA and most of the subprime market is the widespread presence of zero or very little equity in the mortgage at origination. The characteristics of zero or negative equity also explain the poor performance of most subprime adjustable rate mortgages. Many of these loans also had little or no equity upon origination, providing the borrower with little equity cushion when prices fell. Recognizing the critical role of negative equity of course raises the difficult question as to what exactly it is that homeowners are losing in the event of a foreclosure.

"Unnecessary" foreclosures

Central to the arguments calling for greater government invention in the mortgage market is that many, if not most, of the foreclosures being witnessed are "unnecessary" or avoidable. Generally it is argued that investors and loan servicers do not face the same incentives and that in many cases in would be better for the investor if the loan were modified, rather than taken to foreclosure, but still the servicer takes the loan to foreclosure.

The principal flaw in this argument is it ignores the costs to the lender of modifying loans that would have continued paying otherwise. Ex Ante, a lender has no way of separating the truly troubled borrowers, who would default, from those that would take advantage of the system, if they knew they could get a modification just by calling. As long as potentially defaulting borrowers remain a low percentage of all borrowers, as they are today, it is in the best interest of the investor to reject many modifications that might make sense ex post. In addition, lenders may institute various mechanisms to help distinguish troubled borrowers from those looking to game the system.

It is also claimed that the process of securization has driven a wedge between the interests of investors and servicers, with the implication that servicers would be happy to modify, and investors would prefer modifications, but that the pooling and servicing agreements preclude modifications or that servicers fear being sued by investors. The first fact that should question this assumption is the finding by Boston Fed researchers that there is little difference in modification rates between loans held in portfolio versus those held in securitized pools. There is also little evidence that pooling and servicing agreements preclude positive value modifications. According to recent Credit Suisse report, less than 10 percent of agreements disallowed any modifications. While the Congressional Oversight Panel for the TARP has been critical of industry efforts, even that Panel has found that among the sample of pools it examined with a 5-percent cap on the number of modifications, none of the pools examined had actually reached that cap. If few pools have reached the cap, it would seem obvious that the 5 percent cap is not a binding constraint on modifications. In many instances the pooling agreements also require the servicer to act as if the servicer held the whole loan in its portfolio, raising substantial doubts as the validity of the “tranche warfare” theory of modifications.

A careful review of the evidence provides little support for the notion that high transaction costs or a misalignment of incentives is driving lenders to make foreclosures that are not in their economic interest. Since lenders have no way to separate troubled borrowers from those gaming the system, some positive level of negative value foreclosures will be profit-maximizing in the aggregate.

What could reduce the level of foreclosures?

The high level of foreclosures has left many policymakers and much of the public understandably frustrated and searching for answers. To be effective, those answers must be grounded in solid and unbiased analysis. In order to gauge the success of any federal efforts, we must also establish a reasonable baseline. I strongly encourage both Congress and the Administration to present detailed estimates of how many foreclosures are driven by which primary causes and how many of those foreclosures can be reasonably avoided.

Before discussing specific policy proposals, Congress should bear in mind that as approximately 50 percent of foreclosures are currently driven by job loss, the most significant way to reduce foreclosures is to foster an environment that is conducive to private sector job creation. Accordingly, the worst thing Congress can do is to insert uncertainty into the job market, pushing employers to the sides-lines.

In addition to focusing on owners currently in foreclosure, efforts can also be made to reach families before they fall behind on their obligation. For instance, approximately 4 million jobs have been lost in "mass lay-offs" since the beginning of the current recession. Mass lay-offs represent a double shock to households: the loss of a job along with a shock to the local housing market as the result of a major employer downsizing. As damaging as mass lay-offs can be, they do have one advantage – we know about them ahead of time, as the Department of Labor (DoL) collects data on mass lay-offs and workers must be given notice of such. Despite the strong connection between mass lay-offs and foreclosures, there is almost no coordination between DoL and HUD (or the many non-profit organizations providing housing assistance). DoL and HUD should partner in an effort to provide currently appropriated housing counseling funds to workers when they receive a notice of mass lay-off.

Congress can also encourage bank regulators to give lenders more flexibility to lease out foreclosed homes to the current residents. Typically banks come under considerable pressure from their regulators not to engage in long term property leasing or management, as that activity is not considered a core function of banks. I believe we can avoid the larger debate of banks being property managers by giving banks greater flexibility in retaining properties with non-performing mortgages as rentals, preferably to current residents. In addition to many owners who may wish to stay in their homes as renters, approximately 20 percent of foreclosures occur on renter-occupied investment properties. If current renters can continue to make their rent, many banks may prefer to keep those renters rather than proceed to a foreclosure sale.

In order to separate out deserving borrowers, who are trying to get back on their feet, from those simply walking away from a bad investment, Federal lending entities, such as FHA and the GSEs, should engage in aggressive recourse against delinquent borrowers who have the ability to pay, but simply choose not too. All federal modification programs should also include strong recourse provisions. We should make every effort to turn away from becoming a society where legally incurred debts are no longer obligations to be honored but simply options to be exercised.

Lastly, Congress and the Administration should focus resources on those households most in need, who *but for* an intervention, would lose their home. Programs aimed at households who are not facing foreclosure, but simply cannot re-finance due to being "underwater" on their mortgage should be ended. These programs draw off limited lenders/servicer resources that should instead focus on at-need families.

Conclusions

In concluding my testimony, I again wish to strongly state: the current foreclosure relief efforts have largely been unsuccessful because they have misidentified the underlying causes of mortgage default. It is not exploding ARMs or predatory lending that drives the current wave of foreclosures, but negative equity driven by house prices declines coupled with adverse income shocks that are the main driver of defaults on primary residences. Defaults on speculative properties continue to represent a large share of foreclosures. Accordingly, for any plan to be successful it must address both negative equity and reductions in earnings.

Given the relatively low number of actual permanent modifications under HAMP, it is likely that the program's overall impact has been negative. First, the program has delayed the needed adjustment in the housing market. HAMP also has likely provided an incentive for additional borrowers to withhold mortgage payments in order to receive modifications, pushing some of those borrowers into delinquency while also diverting limited resources to households not at risk of foreclosure.. I thank you for your attention and welcome your questions.

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