

**Statement of**

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**Before the Domestic Policy Subcommittee on of the Oversight and  
Government Reform Committee**

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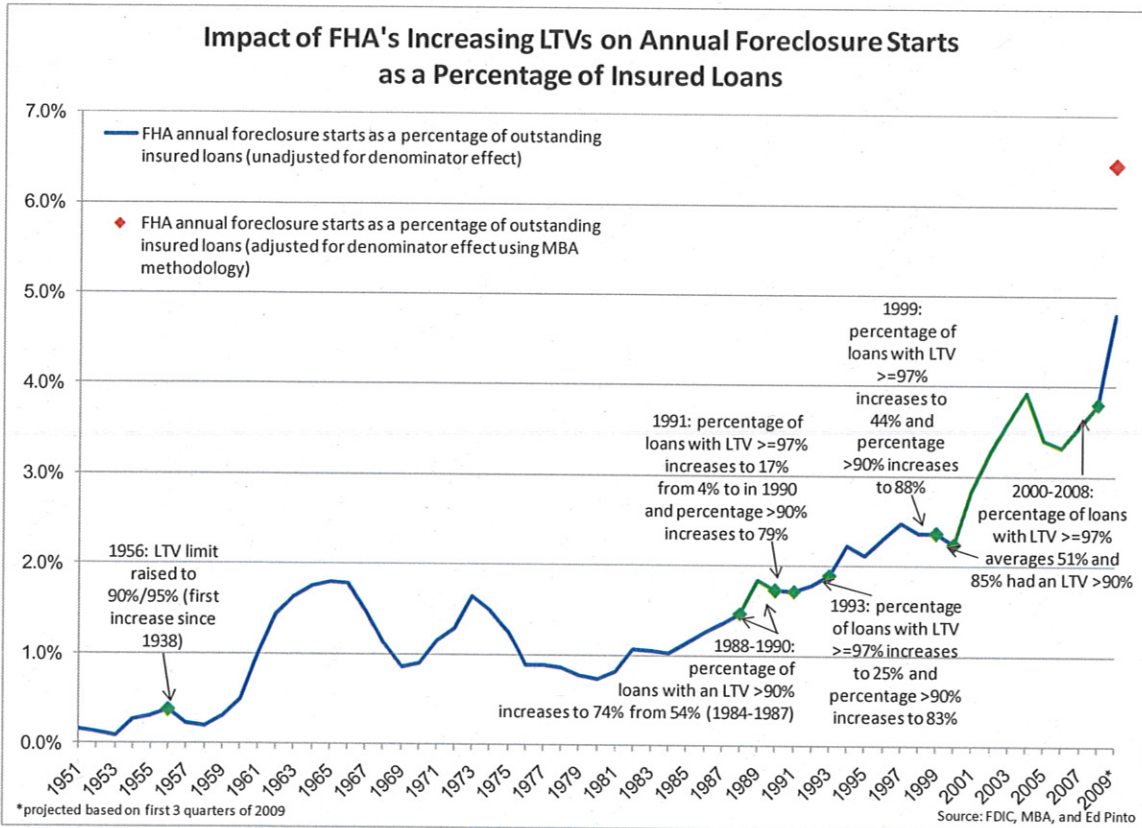
**Chairman Kucinich and Ranking Member Jordan, thank you for the opportunity to testify today. I am an expert in credit risk methodologies and loan performance metrics. I was Fannie Mae's chief credit officer from 1987 to 1989. In the mid-1980s I was responsible for Fannie's single and multi-family marketing,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

**My purpose in testifying today is to discuss the impact of the Administration's response to the ongoing foreclosure crisis.**

**Given the committee's oversight role, let me first provide some background regarding the causes of the foreclosure crisis.**

**Foreclosures have been increasing for almost 60 years. As Chart 1 demonstrates, FHA's foreclosure start rate now stands at 32 times the level in 1951:**

**Chart 1:**



Sources: FDIC, MBA, FHA's 2009 Actuarial Study, Thomas Herzog, and Edward Pinto

Starting in the early 1990's the full force of the federal government was brought to bear on increasing affordable housing. The method chosen was a comprehensive and organized effort to loosen underwriting standards nationally. It was in the first half of the 1990s that the federal government adopted three policy initiatives that were intended to supplement the work of the Federal Housing Administration (FHA), which had long been the federal government's main vehicle for higher risk home lending:

1. In 1992, Congress imposed affordable housing goals on Fannie and Freddie (Safety and Soundness Act of 1992) and they became both competitors to FHA and a source of demand for CRA loans;
2. In 1994, HUD began to implement its "Fair Lending Best Practices Agreements" with lenders across the nation; and
3. In 1995, the Community Reinvestment Act (CRA), which had been passed in 1977 but had had little impact on bank lending, was given new life with stronger regulations applicable to all insured banks.

These new initiatives covered most lenders and most of the secondary market. Each explicitly (FHA, CRA, and HUD) or implicitly (Fannie and Freddie) required the

use of “flexible” lending standards. The goal was to stimulate housing demand – with all the focus on borrowers with incomes below the median. It also set up a series of “dog chasing its tail” scenarios as the GSEs had to compete with FHA, subprime lenders, and CRA lenders and vice versa, Fannie and Freddie had to both compete with each other and lead the market, and big banks had to leap-frog each other in CRA-performance in order to maintain an outstanding CRA rating, the rating necessary to get mergers approved, and by the way create “too big to fail” banks..

With these initiatives in place, in 1995 HUD announced the “National Homeownership Strategy”; self-described as “an unprecedented public-private partnership to increase homeownership to a record-high level over the next 6 years”. HUD “forged a nationwide partnership that will draw on the resources and creativity of lenders, builders, real estate professionals, community-based nonprofit organizations, consumer groups, State and local governments and housing finance agencies, and many others in a cooperative, multifaceted campaign to create ownership opportunities and reduce the barriers facing underserved populations and communities.” The goal was to make “financing more available, affordable, and flexible” in order to:

1. Increase ownership opportunities among populations and communities with lower than average homeownership rates;
2. Reduce downpayment requirements and interest costs by making terms more flexible, providing subsidies to low- and moderate-income families, and creating incentives to save for homeownership; and
3. Increase the availability of alternative financing products in housing markets throughout the country.

Trillions upon trillions of weak loans were originated. Weak lending had a double action effect. It fueled both demand and a massive price boom which enabled unprecedented amounts of equity withdrawals which added additional fuel to a continuing price boom. The line of causation from the federal policy initiatives of the early- to mid-90s to the mortgage meltdown is clear.

We are now living with the consequences of the National Homeownership Strategy. As of June 30, 2008 over 26 million out of 55 million first mortgages had weak underwriting or to use the terms of the National Homeownership Policy – flexibly underwritten or alternative loan products.

- Third, just last week, the Federal Housing Finance Agency, regulator and conservator for Fannie and Freddie, noted “[a] result of the crisis is that the

mortgage market has returned to more traditional and prudent lending standards.” Fannie has reduced its acquisition of high LTV loans by over 80%, of loans with a FICO below 660 by almost 90%, of investor loans by almost 70%, and has reduced “back-end” borrower debt-to income ratios from 50% to 45%. In short it has returned to many of the sustainable lending standards that prevailed before the government mandates for flexibly underwritten and alternative loan products. If FHA would do the same, our real estate markets would be much stronger in the long run. Replacing flexible lending standards with sustainable ones is the best form of consumer protection.

I will now turn to Administration’s Home Affordable Modification Program (HAMP). When evaluating a program, it is always useful to recall the original goal: “[t]o help as many as 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.”<sup>1</sup> This goal was clear cut and unequivocal with the operative words being the avoidance of 3-4 million foreclosures and creating sustainable modifications. Accomplishing this goal would have made a real dent in the estimated 7-8 million foreclosures, deeds-in-lieu, and short sales expected over 2009-2012.

The Treasury Department has consistently painted rosy scenarios regarding HAMP’s progress. Apparently in a desire to post big numbers early on, the 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 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.

The recent 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 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:

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<sup>1</sup> HAMP website

1. In its first 11 months 116,000 homeowners have received permanent modifications. About a third or more of these modifications are expected to re-default, resulting in the avoidance of about 75,000 foreclosures or about 2% of the stated goal.
2. At the rate HAMP is going, out of the pool of 3.4 million HAMP eligible delinquent<sup>2</sup> borrowers at 12.31.09 perhaps only 250,000 homeowners will avoid foreclosure - about 5-8% of the original goal.

The same redefinition of the program goal applies to HARP, Treasury's refinance program. It was designed to help 4-5 million homeowners shut out from refinancing because their current loan to value was above 80%.<sup>3</sup> Through December 31, 2009 Fannie and Freddie had completed 190,000 HARP refinances, less than 5% of the goal.<sup>4</sup> The Making Home Affordable January 2010 report makes no mention of HARP modifications, only to a more generic category called "Making Home Affordable – Refinancing" where credit is taken for 4 million refinances of all types.<sup>5</sup> Treasury promised transparency. What we have gotten instead are disingenuous progress reports that use "bait and switch" when it comes to program goals.

These examples present serious areas for oversight by this subcommittee.

But why is the problem so intractable?

1. We face a more challenging situation than ever before as the Three Cs of Lending - Collateral, Credit, and Capacity - were all severely compromised PRIOR to the onset of the current crisis. Recall the National Homeownership Strategy and the 26 million weak loans I mentioned earlier:
  - a. High LTV lending and loans to credit impaired borrowers were rampant leading up to the crisis.
  - b. Most nonprime loans were "income challenged" to start with due to being a liar loan or payment shock. Under HAMP, the average overall debt ratio after modification is still 60%. Recall that Fannie has reduced its maximum on new loans from 50% to 45%. 45% is still a high ratio by historical standards.

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<sup>2</sup> January 2010 Making Home Affordable report. Delinquent is defined as 60+ days delinquent.

<sup>3</sup> Speech by President Obama: "My plan changes that by removing this restriction [of refinancing for mortgages valued at more than 80 percent of the home's worth] on Fannie and Freddie so that they can refinance mortgages they already own or guarantee. And what this will do is it will allow millions of families stuck with loans at a higher rate to refinance." [http://www.whitehouse.gov/the\\_press\\_office/remarks-by-the-president-on-the-mortgage-crisis/](http://www.whitehouse.gov/the_press_office/remarks-by-the-president-on-the-mortgage-crisis/)

<sup>4</sup> [http://www.fhfa.gov/webfiles/15389/Foreclosure\\_Prev\\_release\\_1\\_29\\_10.pdf](http://www.fhfa.gov/webfiles/15389/Foreclosure_Prev_release_1_29_10.pdf)

<sup>5</sup> <http://www.financialstability.gov/docs/press/January%20Report%20FINAL%2002%2016%2010.pdf>

2. In December 2008 I testified before the full Oversight and Government Reform Committee. I 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.
3. What delinquent borrowers and the housing market need is triage that provides quick answers and fast decisions. This will allow the shadow inventory of millions of defaulted loans that can not benefit from a modification to end up in the hands of qualified homeowners.
4. There are three types of delinquent loans. The first consists of vacant homes with loans often taken out by scammers or investors. These need to be identified quickly and, when necessary, foreclosed on. The second group consists of borrowers who can't or won't pay their mortgages. These borrowers need to be given incentives (either a small amount of cash or the ability to conduct a short sale) to vacate their homes. Many foreclosed homes in these two groups will be scooped up by bargain hunters and either fixed up or rented out, while others will be bulldozed. The third group consists of homes that can be saved because the borrower has a demonstrated ability and willingness to pay. We can best help this group if we stop clogging the system with unqualified borrowers from groups one and two.
5. Finally late last month, Treasury announced changes to the HAMP process which should help meet the goal of providing quick answers and fast decisions. It will hopefully put an end to "no doc" trial modifications. Unfortunately the changes don't take effect for 3 more months.

Treasury should focus on saving the homes of this third group of borrowers by modifying their loans, while foreclosing on those in group one and encouraging those in group two to voluntarily move on with their lives. As I said earlier this group is not 3-4 million homeowners, but perhaps 500,000.

Bottom line – there is no way the current HAMP and HARP can accomplish but a small fraction of their original goals. This subcommittee and the American people deserve an honest assessment of what HAMP and HARP can accomplish.

The TARP Special Inspector General on January 31, 2010 noted that "increasing access to credit increases the pool of potential home buyers, increasing access to credit boosts home prices." Policy makers can't have it both ways. If they want to take credit for the effect that today's housing stimulus is having in terms of boosting or propping up prices, they must also take responsibility for the effect that weak lending had when it fueled both unsustainable demand and price increases leading up to the financial crisis.

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