



Statement by
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Hearing on
“Strengthening our Economy: Foreclosure Prevention and
Neighborhood Preservation”

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to submit a statement for the record for the Banking Committee hearing entitled, “Strengthening our Economy: Foreclosure Prevention and Neighborhood Preservation.” My name is Douglas G. Duncan, Chief Economist and Senior Vice President of Research and Business Development at the Mortgage Bankers Association (MBA).¹ I am presenting MBA’s perspective on the current market, how we can continue to work together to stabilize it, help borrowers in trouble and prevent some of the current problems from occurring again.

Almost one year ago, I came before this committee and discussed the state of the housing market. My testimony focused on how the market was performing and discussed the kinds of loans American borrowers were choosing, how they worked and how market innovation led to increased rates of homeownership. Today, the markets have changed significantly. In a little over a year, we have gone from a market of relatively loose credit, to one where credit is severely constrained. We have, in effect, a mortgage market that is going through a once-in-a-generation transformation. The mortgage market already looks very different from one year ago and it will look different one year from now.

¹ The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 400,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation’s residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2500 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA’s Web site: www.mortgagebankers.org.

What has not changed is mortgage bankers' commitment to provide adequate credit opportunities to increase home ownership and quality rental housing. And when people find themselves in difficulty, lenders and servicers continue to work with them to find a successful outcome, whether through re-payment plans, forbearance, debt forgiveness, loan modifications or other loss mitigation options. There are some people we are not able to help, but it is important to understand that foreclosure is always a last option for our members. It is extremely expensive and represents, ultimately, a failure of our industry to help a homeowner achieve the American Dream.

We continue to believe transparency in the mortgage process needs to be improved to help borrowers understand, shop for and choose the loan to best meet their needs. We also believe a uniform national mortgage consumer protection standard for all homebuyers will simplify the process for borrowers and protect them, facilitate better enforcement against predatory practices and assist the smooth flow of global capital into the mortgage market.

Since last February, it has become clear that industry participants and policy makers needed to respond to the credit crunch and market conditions. In December, Congress passed important legislation extending the mortgage insurance deduction and providing tax relief for forgiven mortgage debt. Also last year, the Federal Housing Administration (FHA) launched the *FHASecure* program to help borrowers, who have made their payments before a rate reset, refinance into a FHA-insured loan. The mortgage industry too has clearly responded. In just the last few months, we have seen hundreds of thousands of borrowers helped through loan modifications, repayment plans and other workout options. Obviously, our goal is to help every

borrower possible, and the industry remains encouraged by how far we have come in a short period of time. Lenders and servicers have made huge strides to increase their capacity to help borrowers and these efforts must continue. We are just now starting to see the results of this stepped up capacity and other industry and government efforts.

Last fall, U.S. Treasury Secretary Henry Paulson and Department of Housing and Urban Development (HUD) Secretary Alphonso Jackson helped the industry form the HOPE NOW Alliance (HOPE NOW), which is actively assisting hundreds of thousands of borrowers struggling to make their mortgage payments through counseling and other outreach efforts. In addition, HOPE NOW has endorsed an American Securitization Forum (ASF) framework that could freeze interest rates for hundreds of thousands of subprime short-term adjustable rate mortgage (ARM) borrowers at their current rates for an additional five years. Modifications under the ASF framework should begin soon and will increase the number of borrowers who are receiving assistance. Add this to the over 370,000 borrowers who servicers assisted in getting a repayment plan or loan modification during the second half of 2007, and we are headed in the right direction. Much still lies ahead of us, but efforts to help borrowers are in place and working.

Fiscal and monetary policy must also respond to the current weakness in the overall economy. Any Congressional action should be with an eye towards increasing liquidity in the mortgage market and increase borrowers' financing choices. Further, Congress should make clear what the rules of the game are, so the current market upheaval is not exacerbated by a rapid change in regulation. These include passage of a uniform national mortgage lending standard, GSE reform

and FHA Modernization. In order for the market to change course, certainty must be realized by consumers, lenders and investors. With the possibility of major investor liability still on the horizon, secondary market participants and mortgage lenders will remain apprehensive of lending to all but borrowers with perfect credit. The longer these fears remain, the longer our housing market will take to rebound.

Current Market Conditions

Fundamentally, the demand for housing is driven by household formation and jobs creation. The single most important step Congress can take to support the housing market is to encourage long-term economic growth through sound fiscal and tax policy. Members of Congress should also recognize that housing and mortgage delinquencies react to economic conditions and are not a key driver of those conditions. States such as Ohio and Michigan have seen an exodus of jobs and population, stranding a significant amount of housing stock and lowering home prices in the region. States such as California, Florida, Arizona and Nevada saw speculative home construction that far outpaced the rate of household growth, causing home prices to retreat to levels of about two years ago. As long as economic growth continues, these Sunbelt states should be able to grow out of their problems. Other sections of the country face more long-term and intractable problems.

Overview of Industry Efforts to Help Borrowers

In my February 2007 testimony, I discussed at length the many different ways mortgage servicers work with homeowners in the loss mitigation process. Loss mitigation can take many different forms, all of which are aimed at one thing: getting the borrower through their financial

problems and able to sustain a loan. Whether through forbearance, a repayment plan, a loan modification or other tools, the goal is to help borrowers remain in their homes.

Historically, the number one cause of delinquencies and foreclosures is job-related. As discussed earlier, this is currently evident in the Midwest, which has lost a significant number of manufacturing jobs.

However, in the last year, delinquency and foreclosure rates have increased due to upward rate adjustments on adjustable rate mortgages (ARMs) combined with falling home prices. With the recent decline in interest rates more homeowners are receiving favorable mortgage rates, either through lessening the burden on ARM adjustments or re-finance opportunities. However, housing price declines make it harder for borrowers to qualify for certain mortgages, such as a loan taken out with a 20 percent down payment (80 percent loan-to-value), for example, may now be a 90 percent LTV loan due to a 10 percent house price decrease.

Historically, delinquency rates tend to peak in the first three to five years after origination. Because more than half of outstanding loans are less than five years old, it stands to reason that delinquency and foreclosure rates would be increasing at this time under normal circumstances. However, these are not normal circumstances. We are facing an unprecedented overhang in the supply of homes, driving down prices in a number of markets. The overbuilding of homes in markets in California, Florida, Arizona and Nevada has driven down prices from unsustainable levels and has directly led to the foreclosure problems in those states. In Michigan and Ohio, the dramatic loss of jobs and general demographic trends have led to vacant houses with too few

potential buyers who can qualify for a loan. The economies of these states are clearly at the root of the housing crisis.

Given increased delinquency and foreclosure rates, lenders are taking significant action to help borrowers. Most of these options were discussed at length in my February testimony, but bear repeating since there has been concern that servicers are not doing enough to help borrowers.

It makes good economic sense for mortgage servicers to help borrowers who are in trouble. Borrowers who are not able to stay current on their loans are very costly to the servicer, who must forward principal and interest payments to investors as well as remit taxes and insurance payments, even if borrowers are not paying them. In addition, significant staff resources must be employed to contact the borrower, assess the situation, work on repayment plans, and if these efforts do not resolve the situation, initiate and manage the foreclosure process.

Informal forbearance plans are generally the first tool servicers employ to help borrowers. Servicers allow mortgagors to miss a payment, with the explicit understanding the payment(s) will be made up some time soon. If the situation is more involved than a short-term cash crunch due to temporary unemployment or illness, a servicer may turn to a special forbearance plan, which will typically combine a period of postponed or reduced payments followed by repayment of the arrearage over an extended time frame.

Loan modifications are the next level of loss mitigation options. A loan modification is a change in the underlying loan document. It might extend the course of the loan, change the rate, change

repayment terms or make other alterations. The changes to the loan, however, are permanent and represent a new contractual obligation for the borrower. Similarly, a servicer may, depending on the agreement the servicer has with the ultimate investor, attempt to completely refinance the delinquent borrower into a new loan.

Servicers, however, can only help borrowers who want to be helped. Borrowers must respond to servicers notices and phone calls. At some point, the servicer has to assume the property is abandoned or the homeowner has no intention of paying off the obligation. This is why the most important thing lawmakers can do is to use the ability to influence the media to get the word out that if borrowers are in trouble they should reach out to their servicer. Servicers are also actively reaching out to borrowers. As part of the HOPE NOW Alliance, servicers sent letters to almost 500,000 at-risk borrowers encouraging them to contact their servicer or a HOPE NOW representative. In addition, mailing of another round of letters began last week, bringing the total to more than 700,000. It is human nature not to want to reach out to the company to which you are indebted. We understand that. If people do not want to call lenders, they should reach out to a housing counselor, a minister, or call 1-888-995 HOPE.

Last week, through MBA's financial assistance, 38 Mayors who were in Washington created public service announcements for their local media markets urging borrowers to do the same thing. We can not stress this enough: the longer it takes for a borrower to reach out to their servicer, the fewer options available to help.

A Snapshot of What the Industry is Doing to Help: 3rd Quarter of 2007

Recently, MBA authored an empirical report on how servicers helped borrowers at a particular point in time, the third quarter of 2007. As indicated earlier, this was before the HOPE NOW initiative got off the ground, so it gives a good sense of servicers' traditional ability to help, while also setting a "floor" from which the industry can be judged moving forward. Attached to this testimony is the paper, "*An Examination of Mortgage Foreclosures, Modifications, Repayment Plans and other Loss Mitigation Activities in the Third Quarter of 2007*," from which several important facts should be highlighted.

During the third quarter of last year, mortgage servicers helped about 183,000 borrowers through repayment plans. They modified the rates or terms on about 54,000 more loans: 13,000 of which were subprime ARM loans, 15,000 subprime fixed rate loans, 4,000 prime ARM loans and 21,000 prime fixed-rate loans. As you can see from these numbers, the industry helped over 230,000 borrowers during the third quarter. More importantly, HOPE NOW has reported that over 250,000 borrowers received repayment plans, another 120,000 received loan modifications for the second half of 2007, and servicers were modifying subprime loans during the fourth quarter at triple the rate of the third quarter.

Misleading Reports Fuel Public Concern

The paper also discussed something known in our industry as the "Moody's 1% Number." In September 2007, Moody's released a study suggesting the mortgage industry had only assisted 1 percent of the people who needed help. A later report then stated it was 3.5 percent. Despite the fact that in its December report Moody's went to great lengths to put the numbers into the right

context, others continue to look at the number of loan modifications solely in terms of loans outstanding. The problem with this type of analysis is that it uses the wrong measures to accurately judge the situation. In the Moody's "*US Subprime Market Update: November 2007*," from which the 3.5 percent is cited, states "a meaningful barometer of the extent to which servicers are undertaking loss mitigation activity was 24%."

Another problem with the initial Moody's analysis, but since addressed in the later report, is that it used as the denominator the complete universe of subprime ARMs whose rates are resetting in a particular period. Only a limited number of borrowers with subprime ARMs can be helped or need to be helped. In the third quarter of 2007, according to MBA's National Delinquency Survey, approximately 70 percent of subprime ARM borrowers were paying on time, although this percentage will continue to fall as a number of subprime ARM borrowers refinance into other loans and the number of subprime ARM loans outstanding continues to fall. Many borrowers refinance prior to the rate reset, and many others default before the rate reset for reasons completely unrelated to the rate reset.

A more appropriate measure is not to look at the numbers of borrowers assisted relative to the number of borrowers who go into foreclosure, but the total number of borrowers helped versus the total number of borrowers who need help. Looking at the foreclosure number by itself is not a good measure because a number of borrowers facing foreclosure cannot be helped by a payment modification plan. Among these are investors, and people who default despite a previous loan modification or repayment plan.

Various groups have used the 3.5 percent figure as a political rally cry. If the 24 percent number is used and then the number of speculator/investment property loans is deducted from the total, you will see a much larger number of borrowers were helped during the specific period. This does not exclude those borrowers who have not been able to comply with their current repayment plans or who have not responded to servicers' efforts to assist them.

Why All Borrowers Can't be Helped

The last group is investors, for whom help is not available. During the housing boom of the last several years, there were a lot of speculators and investors looking to profit from price appreciation. The strength of our economy relies on the willingness of people to take risks, but risk means that you do not always win. During this time, a majority of these properties were purchased to try to capitalize on appreciating home values or to use rents as a source of investment income, or some combination of both. With the downturn in the housing market, a number of these investors are turning away from their properties and defaulting. In the third quarter of 2007, 18 percent of foreclosure actions started were on non-owner occupied properties. Foreclosure starts for the same period for Arizona, Florida, Nevada and Ohio were at 22 percent for non-owner occupied properties. When assessing the magnitude of the assistance being given to borrowers, it is critical that Congress exclude those loans from assistance calculations because the incentives for some investors to continue to pay their loans will not be influenced by a rate freeze, particularly in states like California and Florida. In fact, including them in the freeze will distort investment incentives and increase the likelihood that we will see such excess in the future.

Conclusion

As Congress continues its examination of the current situation in the housing market and our economy, there are a few things that you should consider. Were there loans made that probably should not have been made? Yes, there is no question bad loans were made and there were bad actors taking advantage of a robust housing market. Several key points should be highlighted as we all look to turn this current situation around. In the short term, the most important thing Congress, industry and consumer groups can do is to help those borrowers who are currently in trouble and occupying the home for which they have a loan. The industry has greatly increased its capacity and we are starting to see those results. We must also realize that not all of those loans facing rate resets deserve a workout. We saw a lot of investor and speculator activity and most of those loans should not be used to minimize the good work we are doing to help deserving borrowers. Finally, as an economist, all policy decisions lawmakers might consider over the course of this year and beyond, must take into account what the essential factors are for a healthy and vibrant market.

First, innovation. Whether it's the housing markets or technology, the ability to innovate without over restrictive and prescriptive regulation is one a necessity for a better America. Second is confidence. Right now, we are seeing a lack of borrower, industry and investor confidence. The more policy makers discuss options that would inject additional risk into the market; confidence will remain on the sidelines. It is vital that policy discussions focus on ways to bring confidence back. We need the liquidity that investors bring to market. As the liquidity returns, many borrowers will begin to see their access to credit return. The industry has learned from its mistakes and investors have learned from their mistakes. This can be seen in the types of loans

being made today. We are all focusing our efforts to help borrowers and stabilize our economy. Congress must now carefully consider how it addresses ways to facilitate innovation and bring confidence back into the market.