Testimony of Richard K. Green

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Chairman Frank, Representative Bachus, and members of the committee, thank you for inviting me to testify today as part of this hearing on "Accelerating Loan Modifications, Improving Foreclosure Prevention and Enhancing Enforcement." My name is Richard K. Green, and I am the Oliver T. Carr, Jr. Chair in Real Estate and Finance at the George Washington University. Before teaching at George Washington, I taught at the University of Wisconsin-Madison and the Wharton School of the University of Pennsylvania. In the interest of disclosure, let me note that I worked for Freddie Mac for about 16 months in 2002-03, and that I own a small amount of Freddie Mac stock (whose value is considerably lower than it was six months ago!)

Let me begin by saying that my thoughts on the subprime crisis have evolved considerably over the past year. Last March, I was quoted in *Newsweek* as saying that I thought the damage arising from the subprime mess would be limited. I was clearly wrong. And so as events have changed, my thoughts on appropriate policy responses to the crisis have changed as well.

Mass loan modification is one example of how my views have changed. Not so long ago, I worried about the moral hazard problems that could result from effectively allowing a large class of borrowers to change the rules of a loan after it was originated. When initial loan terms are not

enforced, future investors will be less willing to invest in mortgages, which in turn can reduce the availability of mortgage credit. But this point seems moot at the moment.

Three things have led me to change my mind about modification. First, and most important, is the fact that it will be difficult to preserve macroeconomic stability if we ignore the fact that already dangerous loans will become even more so when their payments increase, sometimes dramatically. For reasons I will describe later in my testimony, I do not think that modification is by any means a panacea. But past experiences in the history of the US mortgage market give us reason to believe that mass modification can be an effective tool for restoring stability to financial markets.

Before the Great Depression, the typical mortgage in the United States had some features in common with many current subprime mortgages: floating interest rates, no amortization, and the possibility of "payment shock.[1]" The payment shock arose from the fact that mortgages had balloon payments: borrowers were forced to refinance regularly. If they could not refinance, they owed a balance roughly equal to half the purchase price of the house.

This housing finance system worked reasonably well until the Great Depression, when bank illiquidity made lenders call loans when they were due. Households rarely had enough cash to pay off their mortgages and so needed to sell their homes to meet their obligations. The lack of liquidity meant that buyers could not obtain financing, so sellers could not sell. This led to waves of foreclosures, followed by real estate owned by financial institutions, which in turn created more illiquidity; and soaring default rates. The market clearly needed a "servicing" solution.

[1] One big difference is that pre-Depression loans usually had low loan-to-value ratios.

In response, the Hoover Administration created the Federal Home Loan Bank System, and New Deal housing finance legislation created the FHA to insure long-term mortgages and the Home Owners Loan Corporation (HOLC) and its successor, the Federal National Mortgage Association, to tie mortgage markets to capital markets. HOLC, backed by the full faith and credit of the U.S. government, raised money in the bond market to purchase non-performing mortgages from depository institutions. HOLC reinstated the loans as 20-year fixed-payment mortgages (Green and Wachter 2005). This can be seen as the first example of mass loan modification. Borrowers were removed from an impossible position (where they had to raise a large amount of cash to pay off a mortgage balance) and placed in a manageable position. At the same time, by changing the terms, the federal government reduced the embedded risk of the loans and therefore increased their value to depositories,[2] which ultimately bought them back from HOLC.

Second, I have come to appreciate that transactions between borrowers and lenders are hardly typical. Even the simplest fixed-rate mortgage, whose cost is a function of rate, term, points, fees, and expected time in the home, is not a straightforward product. Adjustable rate mortgages are more complicated than fixed-rate mortgages; exotic ARMS are even more so. At a conference sponsored by the Joint Center for Housing Studies last week, professors of law and economics from leading universities could not explain in detail all the characteristics of their adjustable rate mortgages. To expect consumers with far less financial acumen to understand the terms of exotic ARMS is unreasonable. It is particularly noteworthy that as we gather more evidence about the characteristics of subprime borrowers, we find that increasing numbers of

[2] This was particularly true since they were insured by the FHA.

subprime loans were going to borrowers with relatively high FICO scores.[3] I have become increasingly convinced that large numbers of borrowers were pursuaded to take on products that they did not understand (I also leave open the possibility that some of the brokers who sold the loans did not really understand them either).

Third, structured finance has made loan modification on an individual loan level difficult. The interests of the different investors in various classes of securities can be in conflict: when a loan is in default, it is possible that investors holding a senior tranch will prefer foreclosure to workout, while those holding junior tranches might prefer workouts. At the end of the day, this conflict could prevent workouts in cases where both borrowers and the sum total of investors would be better off with a workout, indicating that workouts are economically efficient, at least in the short run. But let me raise a flag about problems that might arise: trusts that hold mortgages are supposed to be passive entities. Large numbers of workouts could turn them into active entities, which in turn could, under the terms of the trust, lead to dissolution. The legal implications of all this are well beyond my ken (I am not a lawyer), but they need to be considered as Congress moves forward with legislation such as HR 4178.

In my opinion, as we think about solving the current crisis and developing reforms for the mortgage market of the future, we must keep in mind how important it is to develop incentives that will allow us to get out of our current predicament and prevent future crises. To me, a combination of incentives and improved information will be more effective than detailed regulation (big picture regulation is another matter, and something I will get to in a minute).

[3] Tabulations of Loan Perfomance Data show that the share of subprime borrowers with FICO scores in excess of 660 rose steadily over the course of the decade.

For the time being, the key loan modifications would be: (1) to freeze ARM payments for particular types of ARMS and (2) to allow ARM borrowers whose mortgages have prepayment penalties to refinance without having to pay these penalties. But in determining the level at which to freeze ARM payments, we should not freeze rates below A and alt A rates, both for equity reasons and because we want to encourage borrowers who can refinance into A or alt A products do to so. We also should be sure only to modify loans for borrowers who occupy the house under mortgage.

As we look forward, new regulation should focus on aligning incentives to mitigate against the adverse selection and moral hazard issues that led to the current crisis. To be more specific, changes in policy should accomplish three things:

(1) It should make sure that all parties in the lending chain have "skin in the game." While reputational risk mitigates against bad behavior, there is not a substitute for financial incentives.

(2) It should make sure that all parties in the lending chain are subject to federal supervision. This will reduce regulatory arbitrage.

(3) It should do what it can to improve disclosures throughout the lending chain. Borrowers must be better informed as to the consequences of their lending choices (although this will be difficult); bond ratings must be consistent, and securities must be more transparent.

All this said, it is important to recognize that no amount of modification can produce a panacea to the current crisis. First of all, we know that many defaults occurred before a rate reset, and so they were induced by something other than payment shock. It is actually an

interesting and open question as to whether those borrowers with the greatest propensity to default have already done so. In the distant past (i.e., the 1970s and 1980s), default usually occurred in the third to seventh year of a loan's life. We now have the unusual spectacle of books of mortgages that contain large numbers of loans that didn't receive a single payment. This means history gives us little guidance about how these mortgages will perform going forward.

Second, the current outlook for the housing market is grim. Economic theory tells us that one of the key determinants of current house prices is expectations of future house prices. A very small change in expectations can actually lead to a very large change in house prices. One of the best ways to look at expectations for house prices is to look at the S&P/Case-Shiller futures market for houses[4]; in this market, people actually place money behind their opinions about future house price movement. And right now the market is telling us that people's expectations are not positive. This by itself could push down house prices for awhile, which will eat away at home equity, which will make mortgages more vulnerable. Reducing the possibility of payment shocks and making loans easier to refinance will help, but for a person who loses his job, gets sick, or sees his marriage dissolve, the fact that his mortgage balance is higher than his house value may leave him with little alternative but to default.

Reducing impediments to modification will, however, reduce the probability of foreclosure somewhat, and will therefore reduce the inventory of homes available for sale going forward. This can do nothing but help expectations about future house prices, and therefore make the market less bad than it would otherwise be. I think for the time being, reducing the damage from the subprime crisis is the best we can expect to do.

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[4] See http://housingrdc.cme.com/.