TESTIMONY OF DR. CHRISTOPHER J. MAYER
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON HOUSING, TRANSPORTATION, AND COMMUNITY DEVELOPMENT
HEARING: "HELPING RESPONSIBLE HOMEOWNERS SAVE MONEY THROUGH REFINANCING"
APRIL 25, 2012

Good afternoon Chairman Menendez, Ranking Member DeMint, and Members of the Subcommittee. Thank you for inviting me to speak today. It is my honor to be here. My name is Christopher J. Mayer. I am the Paul Milstein Professor of Real Estate at Columbia Business School. I have spent the last 19 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. I also serve as Visiting Scholar at the Federal Reserve Bank of New York.

This is the sixth time I have been called to testify at a Congressional Committee or Subcommittee hearing, dating back to November 2008, with three of those at the request of Republicans and three from Democratic requests. At all six of those hearings I have advocated for what is a seemingly straightforward and simple policy; allow millions of Americans who are trapped in high interest rate mortgages to refinance their mortgages at low current rates. Tens of millions of American homeowners with mortgages guaranteed by Fannie Mae or Freddie Mac would have been eligible for such a program.[1] Had the Federal Housing Finance Agency (the GSE's regulator) adopted such a policy at that time, conservative estimates suggest that it likely would have prevented over 300,000 defaults, saved taxpayers and GSEs $10 billion in insurance costs from excess foreclosures, helped

[1] Numerous other analysts, investors, or policy makers have called for a widespread refinancing program including, for example, Alan Boyce, David Greenlaw, Bill Gross, Glenn Hubbard, and Mark Zandi. The recent Federal Reserve White Paper pointed out the merits of widespread refinancing, as have Federal Reserve officials and columnists Ezra Klein, David Wessel, and Allan Sloan, and the *New York Times* editorial page.

stabilize the housing market, and saved homeowners about $20 billion annually in mortgage payments. (See Appendix 1 for supporting calculations.)

Today the housing market is being hobbled by excessively tight credit, continuing foreclosures, and lack of consumer confidence, as described by the recent Federal Reserve White Paper. This is not only result of the economic downturn; housing is in much worse shape than the rest of the economy. Auto lending has grown for each of the last two years, while new bankcard credit is up 30 percent from its trough. With credit available at more favorable terms than two years ago, consumer spending and auto sales have grown. By comparison, the National Association of Realtors reports that about 30 percent of existing homebuyers do not obtain a mortgage. The Mortgage Bankers Association Index of Applications for Home Purchase is at its 1996 levels. Consumers are forced to pay almost 0.75 percent more in higher spreads on mortgages relative to before the GSEs were taken over by the FHFA. In other words, many existing borrowers and potential homebuyers have been locked out from the benefits of low interest rates. Excessively tight credit is not just a market outcome; it is a result of policy choices made by government regulators at the FHFA. Without Congressional action, such conditions are likely to continue. As noted below, tight mortgage credit is hampering the recovery and costing taxpayers billions of dollars.

It is not too late to act!

Policy makers can still take important steps to help struggling homeowners, while benefitting taxpayers and helping the housing market. I have been asked to assess the "Menendez-Boxer Discussion Draft," which summarizes legislation that would remove key barriers to refinancing that continue to exist due to policies perpetuated by the Government Sponsored Entities (GSEs—Fannie Mae and Freddie Mac) and their regulator, the Federal Housing Finance Agency (FHFA). This draft legislation sets conditions similar to those proposed by Boyce, Hubbard, Mayer, and Witkin.[2] Under such a program, we estimate that as many as 11.6 million new refinancings would take place. The GSEs would

[2] See http://www4.gsb.columbia.edu/realestate/research/housingcrisis/. One small difference between the draft legislation and our policy simulations is that we do not exempt any mortgages from a widespread refinancing program, while the draft legislation limits the program to mortgages originated prior to June, 2010. This might result in a reduction of as many as 1-2 million mortgages from our policy estimates, but the overall conclusion remains unchanged.

earn additional profits of as much as $23.7 billion, predominantly through preventing 400,000 defaults.[3] The GSEs can charge a higher guarantee fee to pay for any losses to their portfolio. Even considering portfolio losses to the Federal Reserve, we estimate the program is profitable for taxpayers. Our conclusion that widespread refinancing earns profits for the GSEs is quite similar to those in the CBO working paper, although we believe that there will be a much higher take-up rate than that used in the CBO paper.[4]

Of course, there are some tradeoffs. The gains in this proposal come at the partial expense of bondholders, who lose higher interest payments they would otherwise receive if homeowners remain locked in to mortgages at above market rates. Of course, the owners of these bonds knew that mortgage bonds could be prepaid at any time and earned a healthy financial premium over other government guaranteed bonds to accept this prepayment risk. In a normally functioning mortgage market, most homeowners would have refinanced a long time ago, and bondholders would not have received an additional financial windfall over the last several years. Our policy proposal, cited above, discusses the winners and losers of a widespread refinancing program in much more detail, with financial estimates of the gains and losses to all major stakeholders.

HARP 2.0: Some positives, but many more problems

In late October 2011, the FHFA announced changes to the HARP program with the stated goal of increasing eligibility to allow more borrowers to benefit from record low mortgage rates. These adjustments were supposed to be focused on aiding underwater borrowers and increasing competition between servicers, but the results so far have failed to live up to this promise. Although the GSEs already own the default risk on existing mortgages, they continue to put in place hurdles that limit access to refinancing. Thus only a relatively small group of borrowers—estimates range between 2-3 million—will be able

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[3] For comparison, the GSEs currently have about 1.1 million mortgages that are 90-days or more delinquent. We estimate that about 1.2 million borrowers with a GSEs mortgage have lost their home due to a foreclosure, a short sale, or giving a deed-in-lieu of foreclosure after 2008. Preventing 400,000 defaults would represent almost 20 percent of all current defaults or homes lost in the crisis with a GSE mortgage.

[4] See Lucas, D., D. Moore and M. Remy. 2011. "An Evaluation of Large-Scale Mortgage Refinancing Programs," CBO Working Paper 2011-4, Washington DC. See also our response: http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=7219077.

to refinance under HARP 2 and even these borrowers are likely to pay rates well above what a new borrower would pay.

The most serious problem is that existing rules continue to reduce competition, resulting in higher profit margins for large banks and scarce options for struggling borrowers. Representations and warranties risk, the legal obligation for originators to repurchase certain mortgages that become delinquent, remains a huge constraint. For same-servicer refinancings, the lender must only verify that the loan will benefit the borrower, that the borrower has a source of income, and that there have been no late payments in the past 6 months and no more than one in the past year. Conversely, cross-servicer refinancings with either GSE require no payments more than 60 days late in the past year, as well as more detailed employment and income verification (Fannie Mae imposes a maximum DTI ratio and Freddie Mac requires a full underwrite).[5] The new servicer will then be responsible for the borrower representation and warranties risk on the mortgage. This increases the lender's legal risk, discourages competition, and results in refinancings for only the safest borrowers, yet this does nothing to help the position of the GSEs, who already guarantee the original mortgage.

The risk on the property value is waived only if Fannie Mae or Freddie Mac grants an appraisal waiver on the property. In the presence of either borrower or property value representations and warranties risk, upfront profits come with uncertain and potentially large future liabilities. As such, large servicers like Wells Fargo, Citi, and Chase have implemented much stricter underwriting guidelines for mortgages they do not already service, capping LTVs at 105% (in certain cases, the maximum LTV is as low as 80%)[6]. In other words, the high LTV borrowers that are supposedly the target of HARP 2 are often locked out from refinancing from all but their existing servicer. Other non-LTV restrictions also remain, such as Chase's "more stringent FICO, LTV, documentation, debt-to- income

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[5] Goodman, Laurie. "Amherst Mortgage Insight: HARP 2.0 – And The Winner Is… The Largest Banks." Amherst Securities Group LP. 21 March 2012.

[6] Muolo, Paul. "Wells Caps HARP LTVs From Third-Party Lenders." Origination News. 16 April 2012. http://www.originationnews.com/nmn_features/wells-caps-harp-ltvs-1029946-1.html

(DTI), and payment history requirements."[7] Effectively, borrowers run into obstacles and greater costs in obtaining a mortgage from any lender besides their current servicer.

It is also difficult for other servicers to identify and solicit eligible borrowers without knowing who has a GSE loan or the loan's payment history. The GSEs could address this problem by providing a list of all borrowers who are eligible for HARP to approved servicers or notifying borrowers that they are eligible, but have chosen not to.

Of course, existing servicers are taking full advantage of limited competition. Same-servicer refinancings have been enormously profitable, with a recent Amherst Securities report finding profit margins on these refinancings of 3.5 to 6.6 percent, an unheard of profit margin in this business.[8] Without competition, borrowers cannot choose a new servicer if they do not like the quality of service or the loan offer their existing servicer presents.

Some high LTV borrowers cannot access same-servicer originations at any price. Citi has a maximum LTV/CLTV/HCLTV of 125% for FRMs and 105% for ARMs.[9] Given the cross-servicer restrictions mentioned above, a high LTV borrower serviced by Citi is effectively unable to refinance to take advantage of today's low rates. Even worse, some large servicers such as MetLife no longer originate new mortgages, so existing MetLife borrowers have nowhere to go for a same-servicer refinancing.

<u>Some evidence that Freddie Mac tightens credit more than Fannie Mae</u>

Freddie Mac appears to impose greater restrictions on HARP 2 refinancings than Fannie Mae. National Public Radio and ProPublica reported that Freddie Mac created risky securities called Inverse IO Floaters that had the appearance of betting against household refinancing. These securities involve creating a concentrated risk position that pays off only as long as the underlying mortgages continue making payments. Freddie Mac has limited

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[7] Wei-Ang Lee and Nicholas Strand. "Prepayment Commentary: Speeds underwhelm." Barclays. 13 April 2012.

[8] See Goodman, above.

[9] Rob Chrisman. "GMAC "Significantly Scales Back"; Citi's HARP 2.0; Lots of Investor, Agency, MI, and Conference Updates." Mortgage News Daily. 14 April 2012. http://www.mortgagenewsdaily.com/channels/pipelinepress/04142012-citimortgage-harp-2-0.aspx

HARP 2 refinancings to borrowers with an LTV above 80 percent and locked out borrowers with a CLTV over 105 percent, rules not imposed by Fannie Mae.

Even if a borrower appears to meet the rules for a HARP 2 refinancing, the loan approval process may be derailed by additional underwriting restrictions that are not disclosed. According to reports from loan officers, "…aside from the current mortgage not having any late[payment]s within the last 6 months and only one 30 day late within the last 12 months, according to Freddie Mac any revolving or installment late within the last 12 months could kill the deal. Lastly, it is rumored that revolving debt that is over 50% of the credit limit, in spite of good credit scores, will cause Freddie Mac to deny/decline the application. And considering most equity lines are coded as revolving accounts and are typically over 50% of their credit limit, most Freddie Mac loans will not be refinanced."[10] HARP's unclear guidelines and implementations inevitably lead to additional costs for borrowers: Bridgeview Bank Mortgage Co. reports that just 1 of about 100 borrowers applying for a HARP refinancing have been approved; elsewhere a borrower was rejected because he had originally begun applying for a refinancing at a different bank.[11]

Freddie Mac has announced that it would be "fine-tuning" its standards. However, "specifics of how the automated underwriting models will be altered aren't being disclosed, even to lenders, but some homeowners who have been turned down for the program may now qualify."[12] For a refinancing program to have success, the rules and eligibility requirements should be fully disclosed to both lenders and borrowers. This opaqueness serves no clear purpose other than to give the appearance that Freddie Mac is a reluctant participant in HARP 2 refinancings.

Finally it is unclear why any existing loans should be ineligible for HARP 2, which locks out mortgages originated after May of 2009. Over $880 billion of outstanding GSE MBS has been issued in 2009 or later with a coupon of 4.5% or higher (mortgage rates are

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[10] See Lee and Strand, above.

[11] Podmolik, Mary Ellen. "Freddie Mac to ease refinancing program's guidelines for borrowers." Chicago Tribune. 15 April 2012. http://articles.chicagotribune.com/2012-04-15/business/ct-biz-0416-freddie-harp-20120414_1_freddie-mac-refinancing-program-largest-servicers

[12] See Podmolik, above.

typically roughly 50 basis points above the coupon).[13] A borrower receiving a 5.25% mortgage in 2010 due to the tightening of credit and lack of competition in the mortgage market is no better off than a borrower who obtained an identical loan in 2007.

HARP 2 restrictions appear to violate FHFA's mandate

As I noted in my testimony before the full committee on February 9, 2012, the FHFA appears to be in violation of its Congressional mandates. In 2008, Congress passed the Housing and Economic Recovery Act (HERA). Under HERA, the Director of the FHFA must ensure that the GSEs meet a number of conditions, including:[14] "each regulated entity operates in a safe and sound manner…"; "the operations and activities of each regulated entity foster liquid, efficient, competitive, and resilient national housing finance markets…"; "the activities of each regulated entity and the manner in which such regulated entity is operated are consistent with the public interest." As well, under conservatorship, the FHFA must "preserve and conserve the assets and property of the regulated entities..." Finally, the Emergency Economic Stabilization Act of 2008 (EESA) specifies that the FHFA "…has a statutory responsibility to maximize assistance for homeowners to minimize foreclosures."[15]

Many commentators focus on the requirement to preserve and conserve assets in explaining the GSE's behavior towards refinancing. According to this line of reasoning, the fact that the FHFA and the GSEs have taken active steps to restrict refinancing might be justified in order to protect the value of its retained portfolio of mortgage-backed securities. Many of these mortgage-backed securities were acquired at a time when mortgage rates were much higher than today and thus prepayments due to refinancing could cause appreciable portfolio losses.

These policies under HARP 2 described above may at first pass seem consistent with

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[13] Data courtesy of Knowledge Decision Services LLC. Based on pool-level data on Fannie Mae and Freddie Mac MBS. Current as of March 2012.

[14] See H.R. 3221-11. I have abbreviated the rules to focus on the relevant parts of the legislation for this testimony. This is not a complete list of all legislative requirements.

[15] See FHFA letter to Congressman Cummings: http://www.fhfa.gov/webfiles/23056/PrincipalForgivenessltr12312.pdf.

the strategic goal of preserving and conserving assets, even if the policies violate the mandate to "foster liquid, efficient, competitive, and resilient national housing finance markets" and to operate in a manner "consistent with the public interest." As noted above, policies that restrict refinancing include limiting competition by giving existing servicers preferential legal treatment for "Reps and Warranties" relative to new servicers, imposing opaque credit restrictions that make the market less transparent (and thus less efficient), and limiting access to a program that lowers borrowing costs and reduces foreclosures (seemingly against the public interest). Each of these restrictions under HARP 2 violates a specific provision of HERA and/or EESA. Nonetheless, following this line of reasoning, and in the face of conflicting mandates, the FHFA must choose one mandate over another.

Of course, Acting Director DeMarco has said that there is no conflict because the GSEs were not supposed to consider their portfolio in implementing HARP 2. When responding the NPR/ProPublica report listed above, the FHFA stated, "In evaluating changes to HARP, FHFA specifically directed both Enterprises not to consider changes in their own investment income as part of the HARP evaluation process."[16]

Absent such conflicts, independent analysis by the Congressional Budget Office undermines the argument that refinancing restrictions serve even the single goal of conserving assets. According to the CBO Working Paper, cited above, a widespread refinancing program would result in higher profits for the GSEs, even taking into account portfolio losses, because more refinancings lead to fewer defaults and lower insurance costs. The CBO estimates a $2.5 billion "reduction in subsidy cost on GSE guarantees" and $1.8 billion "lost portfolio value to GSEs" for a net impact of $0.7 billion in profit for the GSEs.

My own analysis with co-authors, also cited above, takes the CBO case one step further. Suppose that refinancing did impose net portfolio costs, or suppose that the GSEs must give up valuable legal rights to sue for reps and warranties violations (a case that most independent analysts doubt); in either circumstance, the GSEs could just charge a slightly higher annual fee to pay for any incremental costs. Our analysis suggests that a

[16] Federal Housing Finance Agency. "FHFA Statement on Freddie Mac Refinance Story." 30 January 2012. www.fhfa.gov/webfiles/23178/ProPublicaNPRFHFAStmt13012.pdf

streamlined proposal could achieve healthy profitability for the GSEs simply by increasing the annual guarantee fee by 15 basis points and adding a 7 basis point annual fee to cover losses from waived representations and warranty liabilities. In their analysis, the CBO found that "potential recoveries from put-backs on mortgages refinanced under the program that would not have been refinanced without the program appear to be relatively small," suggesting that our 7 basis point annuity will be more than sufficient to compensate the GSEs for relieving lenders of this risk. In net, we find that our proposed program would lead to a profit for the GSEs of more than $23.6 billion. Thus there really is no trade-off between conserving assets and supporting a competitive and efficient mortgage market.

Finally, it is possible that a widespread refinancing program might lower the price of mortgage bonds in the future because investors would require a large premium to cover refinancing risk. The fact that managers at Pimco, Morgan Stanley, and Moody's Analytics have argued in favor of widespread refinancing makes it less likely that a revolt by bond buyers is a serious concern. Counter to such a suggestion, securities backed by these refinancings have turned out to be quite appealing to investors given their low prepayment risk. An article examining MBS backed by HARP 2.0 refinancings found that "recent trades show that demand for the >125% LTV pools is strong… Investors are apparently willing to accept the reduced liquidity of the securities and still pay through the TBA market for glacial prepayment speeds and the resulting boost in carry."[17] As well, about 25 million borrowers refinanced their mortgages in 2002 and 2003, much larger than is envisioned by even the most optimistic projections. So a high rate of refinancing is far from unprecedented.

Conclusion

It is not too late to achieve a win-win scenario. The FHFA has the authority to pursue a widespread refinancing plan, and such a program seems to be called for by existing mandates. However, the FHFA has chosen not to do so and appears unlikely to change course without outside intervention. As a result, Congress should act to reinforce

[17] Berliner, Bill. "Trading in MBS Pools Backed By HARP Loans." Mortgage News Daily. 18 April 2012. http://www.mortgagenewsdaily.com/channels/secondary_markets/04182012-trading-pools-harp-loans.aspx

the mandate of conservatorship with regard to refinancing and credit availability. The "Menendez-Boxer Discussion Draft" addresses the key problems listed above.

Nonetheless, I have two additional suggestions. First, all mortgages originated prior to the date of passage should be eligible for the refinancing program as long as they are current at the time of application. Existing FHFA rules have limited competition, so most borrowers are paying higher mortgage rates than would prevail in a more competitive mortgage market as envisioned under this draft legislation. All of these borrowers deserve relief. Second, I believe that legislation should mandate that an independent trustee be appointed to wind down the GSE's retained portfolio of MBS. The GSEs could continue to retain non-performing loans that they have bought back from securitizations as is necessary to perform their mortgage guarantee business. Independent management of the retained portfolio will make the eventual privatization or replacement of the GSEs considerably easier.

Finally, I would make one other argument in favor of a legislative solution. The Federal Reserve has often pointed to the housing market as a key justification for its controversial policy of quantitative easing. Yet low interest rates benefit relatively few borrowers under existing FHFA policies. Repairing large flaws in the mortgage market will help ease pressure on the housing market. Under these circumstances, the Federal Reserve may feel comfortable reducing the amount of quantitative easing, leaving it room to exit more quickly from existing bond holdings.

Until we fix the housing market, it will be hard for the economy to fully recover. I believe that immediate action is necessary to address fundamental flaws in the structure of the GSEs. Conservatorship as it now stands is laden with conflicts of interest between lending and portfolio management and holds back the re-introduction of private capital. These steps can occur now, even without a consensus on what the future of the US housing finance system will look like.

I appreciate the opportunity to address you today and look forward to answering any questions that you might have.

<u>Appendix 1:</u> Estimating losses from failing to adopt a widespread refinancing plan

Below I present simple calculations to get an order of magnitude of losses from the failure to adopt a widespread refinancing program. These estimates are intended to be a conservative, but reflect rough calculations and not a detailed study.

In an earlier analysis, Boyce, Hubbard and Mayer summarize various studies of the take-up of an appropriately structured widespread refinancing program.[18] Moody's Analytics and Morgan Stanley estimates from 2010 suggest that such a program would have resulted in about 18 million mortgages that would be refinanced, saving homeowners $46-56 billion annually in lower mortgage payments. These estimates include FHA and VA loans, which at the time represented a distinct minority of all outstanding mortgages. For these calculations, I assume that about 14 million of the 18 million refinancings would be for GSE mortgages.

Instead, the GSEs accomplished about 10 million refinancings, of which a significant share are either multiple refinancings for the same borrowers or refinancings of mortgages originated after April 1, 2009. Assuming about 40 percent of the refinancings are for mortgages that were originated after 4/1/2009 or to borrowers that refinanced more than once, this suggests that about 6 million legacy mortgages were refinanced instead of 14 million as might have happened with a widespread refinancing program. So, policy resulted in about 8 million "lost" refinancings.

Next, I compute the economic outcomes associated with the lack of appropriate refinancing activity. According to a Congressional Budget Office study[19], every 1,000 refinancings result in 38 fewer defaults (3.8 percent). So 8 million "lost" refinancings resulted in about 304,000 unnecessary defaults. Using CBO estimates of the cost per default, these additional defaults have cost taxpayers about $10.75 billion in higher insurance costs for the GSEs. As well, Moody's Analytics, Morgan Stanley, and the CBO estimate that each refinancing saves homeowners between $2,500 and $3,000 per year.

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[18] http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=7219077

[19] Lucas, D., D. Moore and M. Remy. 2011. "An Evaluation of Large-Scale Mortgage Refinancing Programs," CBO Working Paper 2011-4, Washington DC.

Using $2,600 from the CBO, these lost refinancings "cost" homeowners an additional $20.8 billion annually in higher mortgage costs.

I believe these estimates are quite conservative. By comparison, Boyce, Hubbard, Mayer, and Witkin currently believe that about 11.6 million new borrowers would take-up an appropriately structured refinancing program today.[20] Assuming the GSEs charge a higher annual guarantee fee, they can earn a profit for taxpayers of about $23 billion, taking into account an estimate of losses to their portfolio of mortgage-backed securities as well as savings from fewer defaults. These refinancings would save homeowners about $123 billion over 10 years and prevent about 440,800 defaults.

[20] See http://www4.gsb.columbia.edu/realestate/research/housingcrisis/.