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Before the
United States Senate Committee on Banking, Housing, and Urban Affairs
Hearing on
"Strengthening our Economy:
Foreclosure Prevention and Neighborhood Preservation"
January 31, 2008

Chairman Dodd, Ranking Member Shelby, and distinguished Members of the Committee, it is an honor to be here today to discuss with you measures to strengthen our economy, help to prevent foreclosures, and preserve our neighborhoods.

My testimony today is based on work that I have been doing with the Center for American Progress (CAP) and a team of experts from academia and a wide range of public and private sector institutions.[1] Shortcomings, of course, are my own.

Many homeowners are under water and drowning fast, with loans far larger than their homes are now worth. Our neighborhoods and communities are suffering. And contagion from the housing crisis is drying up credit markets. We risk a vicious downward spiral in housing prices, credit markets, and the real economy. Strong government policy is needed to restore stability and confidence and to head off a long period of recession and stagnation. The time to act is now.

The thrust of our suggestion is to provide new authorities to existing public and private institutions to help resolve the mortgage crisis, push through the backlog of loan modifications for homeowners, restore confidence and liquidity to America's financial markets, and provide a needed boost to the economy. For shorthand, we've been calling the approach, Saving America's Family Equity, or SAFE. Under the proposal, through a Treasury pricing platform, FHA lenders/Ginnie-Mae issuers and the Government-Sponsored Enterprises (GSEs) would buy out existing pools at a market-determined discount and would arrange through responsible existing origination channels for the refinancing of the loans at terms that reduce the likelihood of default, foreclosure, and liquidation. The SAFE loan plan would provide a restructuring process to help borrowers stay in their homes. Over time, our expectation is that market-pricing and liquidity will be restored, and the SAFE loan plan would have an automatic shut-off valve at that point.

The SAFE loan plan I will outline today is broadly consistent with Chairman Dodd's call for a Federal Homeownership Preservation Corporation and related efforts being advanced not only by the Center for American Progress but also by my

[1] The Center for American Progress (CAP) proposal for the Family Foreclosure Rescue Corporation, an updated version of the Home Owner's Loan Corporation, was first described in Andrew Jakabovics, "Throwing Homeowners a Lifeline: A Proposal for Direct Lending to Qualified Troubled Borrowers," Center for American Progress, 2007. Legislation based on that proposal was introduced in the House by Representative Baca as H.R. 4135. CAP has assembled a team of experts who are working together to adapt that initial idea to existing instruments and delivery systems on a wholesale basis, so that a solution might be able to be put in place more quickly than if one created a new government entity. The team of experts working on the proposal includes David Abromowitz, Michael S. Barr, Andrew Jakabovics, Susan Wachter, Sarah Wartell, Ellen Seidman, and Laura Tyson (see Appendix A).

distinguished fellow panelist, Alex Pollock of the American Enterprise Institute. The policy options I will discuss today are based on principles of shared responsibility for the crisis we are in, and shared opportunity to move forward together.

Our plan is designed not just to help out those facing foreclosures but to contain the severe contagion effects of foreclosures on property values; consumer credit, spending, and confidence; commercial real estate markets; and the functioning of credit markets. An unprecedented number of foreclosures and liquidations under current market conditions, with the crisis of confidence and liquidity in credit markets, will result in home price declines that would not occur under normal market conditions.

We need a mechanism for market investors transparently to take their losses, home owners to stay in their homes, and financial institutions to build capital, in order to stabilize the market and restore confidence in our financial system. Our policy proposal is decidedly not a bailout for either investors or for mortgage holders who made unwise or speculative decisions. Rather, the SAFE plan can help to keep families in their homes, clean up the credit markets, contain the contagion and avoid a vicious downward spiral that drags down the economy. Monetary and fiscal policy alone, while important, cannot restore liquidity, stability, and confidence to credit markets.

The Current Housing and Financial Crisis

Today, our economy is facing a real and growing crisis, threatening the longest, severest liquidity crisis and period of economic stagnation since the Great Depression. Nowhere is that problem more evident than in the wave of home foreclosures, which are already up by more than 40 percent over last year. Even with recent initiatives undertaken by Treasury and the private sector, up to two million foreclosures are anticipated within the next two years. In addition to the pain caused to individual homeowners, there are significant spillovers to neighborhoods and communities, and foreclosures are further increasing available housing stock and further depressing home prices. Currently, half a million new homes and nearly four million existing homes are up for sale, with inventories having grown to more than nine months of available supply.

Nationally, home prices have already fallen by over six percent from last year, according to the S&P/Case-Schiller Home Price Index. The NAR measured median home price has fallen nationally for the first time since the Great Depression. According to one estimate, home prices may decline by 24 percent before reaching bottom.[2] In the process, home price declines are wiping out family equity and with it the average American's rainy day fund, asset to fund college tuition, and retirement nest egg.

It is not only subprime or other at-risk borrowers who are brought down. Foreclosures and steeply falling house prices affect their neighbors who may have paid off their mortgages long ago, their communities whose tax bases are eroding quickly, and by extension, all Americans. Homebuilders see vacant properties and half-built projects, and construction workers are facing layoffs. Rapid and sustained declines in home equity depress consumer spending, contributing significantly to erosion in the real economy. Further declines in home prices, moreover, significantly and predictably increase defaults

[2] Lawrence H. Summers, "Risks of Recession, Prospects for Policy," Brookings Institution, December 19, 2007.

and foreclosures, and the vicious cycle of house price declines, defaults, and foreclosures continues. It is generally agreed that we are not close to seeing the bottom.

The Federal Reserve reports that 21 percent of subprime loans were 90 days or more past due or in foreclosure as of the third quarter of 2007, with more than 350,000 new foreclosures in that quarter alone. Delinquencies, defaults, and foreclosures are likely to continue to worsen as borrowers with subprime, adjustable-rate mortgages face significant rate resets, and continued house price reductions prevent these borrowers from refinancing. In addition, problems in the subprime sector are appearing in the "Alt-A" and prime markets and fear of contagion may be helping to generate problems in other credit markets as well. With this deterioration, there has been significant credit tightening that is contributing to slowing the economy. As the Treasury Department recently stated, "[f]inancial markets have deteriorated considerably since the start of the year and credit conditions for households and businesses remain tight."[3] Many observers believe that there is a serious risk of a sustained recession, or worse.

A significant portion of our capital markets appear to be frozen. It is self-evident that large mortgage pools have significantly increased in risk and declined in value, but real transparency is lacking. As former Treasury Secretary Lawrence Summers has stated, a "capital market where the same loan is valued at one price in a bank, another in a different bank, another in a conduit and yet another as a hedge fund asset to be margined cannot be the basis for sound economic performance."[4] Moreover, the capital markets have, to date, not been able to unlock these pools through sales or widespread restructuring of the underlying mortgages. Investors cannot determine the value of their assets, and servicers fear legal liability if they restructure mortgage pools without having a market mechanism and established industry practice to determine that the restructurings are consistent with their obligation to investors. In the absence of a mechanism to determine pricing and establish a new standard practice of broad restructuring or refinancing, servicers have been reluctant to act.

The dangers of a weakened economy further undermining the housing market and the housing recession providing negative feedback to a declining macro-economy are real. We need only look to the midwest states such as Michigan and Ohio to see the severe effects of the interaction of falling housing prices and unemployment. If declining housing prices become the long-term expected norm, we would be in unchartered territory. Many mortgages, and other credit instruments, would then be in danger.

Save America's Family Equity (SAFE) Loan Plan

There is no silver bullet for these problems. Undoubtedly, monetary policy and fiscal stimulus will continue to play important roles, but they are not enough. There is a growing consensus among economists and financial experts that a range of housing-specific initiatives are required. As Yale economist Robert J. Shiller has recently written, "[w]hile a temporary tax cut and interest rate cuts are good ideas, they don't address the

[3] Treasury Assistant Secretary for Economic Policy Phillip Swagel, Statement for the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association, January 28, 2008.
[4] Lawrence H. Summers, "Beyond Fiscal Stimulus, Further Action is Needed," *Financial Times*, January 27, 2008.

underlying crisis of confidence… [and] they won't restore faith in the financial markets."[5]

FDIC Chairman Bair has testified to the importance of accelerating loan modifications and broadening the rate set freeze that the private sector, bank regulators, and Treasury announced last month. Chairman Bair has correctly pointed out that the progress thus far has been quite limited. Only 28,000 loans were modified in the third quarter of last year, according to data released by the Mortgage Brokers' Association. The mortgage servicing industry appears ill-equipped to handle millions of individualized decisions regarding loan modifications. I strongly agree with Chairman Bair that a broad, streamlined approach is required. Even with a broad approach to freezing resets, however, many mortgage loans will undoubtedly continue to fail, as home prices continue to decline, credit markets stall, and the economy continues to slow.

One potential strategy is to use an approach modeled in part on Roosevelt's successful Home Owners' Loan Corporation (HOLC), updated to the realities of today's financial marketplace and relying on existing private and public institutions for immediate implementation. A brief history of the HOLC may help set the context.

A Brief History of the Home Owner's Loan Corporation

In 1933, when a larger share of all homes—one percent of every housing unit in the country—went into foreclosure than any other time in American history, President Roosevelt and Congress worked together to establish the Home Owners' Loan Corporation. The HOLC was authorized to issue new loans to replace the existing liens of homeowners in default. Instead of a short-term, interest-only loan, the HOLC loans were fully amortizing over 15 years. In addition, the HOLC was far more patient with borrowers than the banks could have been, and delinquent loans received individualized attention, including debt counseling, family meetings, and budgeting help. Of the nearly 1.9 million applications to HOLC between June 1933 and June 1935, half were withdrawn or rejected. HOLC provided widespread assistance, but homeowners had to demonstrate a determination to meet their financial obligations and a history of doing so.

In order for the HOLC to issue a loan, it needed to pay off the existing liens. This potentially posed a serious problem, as HOLC loans were never to exceed 80 percent of the appraised value of a property, which was often below the outstanding loan balance. The HOLC had to convince the existing lenders to accept those losses. The HOLC was able to succeed because it made lenders an offer they couldn't refuse: A government guarantee of four percent interest in the amount of the new loan, which was worth far more—even at a reduced valuation—than the zero percent they were effectively getting from delinquent loans. Add to that the cost of servicing, foreclosure, and disposition, and the decision to take HOLC's offer was clearly sound.

The HOLC actively issued loans for only three years, between 1933 and 1936. It was a short-term entity designed to deal specifically with the problem of widespread foreclosures. After 1936, the HOLC existed only to service existing loans and dispose of the properties it acquired through foreclosure. The HOLC was liquidated in 1951 at a small profit. Despite its short active lifespan, its innovations have had a long-lasting impact, from the government-insured loans offered by HOLC's successor, the Federal

[5] Robert J. Shiller, "To Build Confidence, Try Better Bricks," *New York Times*, January 27, 2008.

Housing Administration, to the long-term, fully amortizing "conforming" loans offered to homebuyers today that are backed by the GSEs.

Policy Options to Implement the SAFE Loan Plan

We need a plan that will solve two puzzles: First, how can the market move rapidly and transparently to re-price existing mortgage pools, build capital, and restore financial stability? Second, how can the market renegotiate millions of home mortgage loans to avoid widespread defaults, foreclosures, and broader contagion? Both problems must be addressed to get us out of this crisis.

We at CAP have begun to explore options in this regard, and I would like to share our provisional thoughts to help keep more homeowners in their homes and reinvigorate the housing credit markets. CAP initially suggested that Congress consider creating a wholly new corporation; however, we have concluded, given the swift housing downturn, that we simply do not have time to build a new government entity from the ground up, and in many ways, we do not need to do so, because unlike the crisis in the 1930s, we have institutions today that can be readily adapted to serve these goals. With new authorities, Treasury, the FHA, and the government-sponsored enterprises can be brought together under a homeownership corporation to implement the SAFE loan plan.

We need to accelerate the re-pricing of existing mortgage pools to improve market transparency, end uncertainty, and restore liquidity to the credit markets. Ideally, the markets would do this work themselves, but they are not. Investors cannot price their assets, and servicers and trustees are not willing to move aggressively to sell at a discount in the face of uncertain values, lack of standard industry practice, and the potential for investor lawsuits. Divided ownership and conflicts of interests generated in part by tranches and layers of securitization, as well as tax consequences, further complicate the process. Meanwhile, delays in restructuring troubled loans further erode value. The servicing industry is under enormous strain and appears to lack the revenue stream, incentives. and operational capacity to modify millions of individual loans. Moreover, given current market conditions, there is simply no liquidity to fund new loans that would enable borrowers to exit. The key is to speed up the sale of mortgage pools, refinance at-risk loans, and restore liquidity and confidence to the credit markets.

One possibility is for the Treasury Department to establish an auction or similarly transparent market platform for the re-pricing of mortgage pools at a steep discount. Through back-to-back transactions, SAFE participants would be the ultimate purchasers. Investors would get liquidity and certainty in exchange for reduced principal value and lower yield. Treasury engagement would bring all key industry participants to the table, promote standard industry practice, and provide a platform for transparent price discovery. Treasury's platform would be "triggered off" automatically if the discounts offered are not sufficiently steep. Requiring a steep discount to continue the program would ensure that the program ends automatically when the private market for mortgage pools is on a path toward being restored.

Once the mortgage pools have been re-priced, SAFE participants—FHA-lenders/Ginnie Mae issuers and the GSEs would sort the loan pools into "buckets" using core criteria set in advance—into those loans that should be refinanced, those loans that could continue on current terms with sufficient underlying home equity, and loans that cannot be reasonably restructured at affordable terms and values and must go into foreclosure. The core criteria would include debt-to-income ratio, loan-to-value ratio, and payments made to date. Only owner-occupied homes could be refinanced. By sorting the pools into buckets in advance, SAFE participants could reduce the costs of refinancing.

Using existing origination channels, SAFE participants would arrange for the refinancing of the eligible loans into new, fixed rate, 30-year mortgages. Prepayment penalties would be waived. Ultimately, these mortgages would be pooled into securities and sold into the secondary markets. Loans originated through FHA-lender/Ginnie-Mae-issuer channels would be FHA-insured and Ginnie Mae guaranteed. Other SAFE loans would be securitized by Fannie Mae and Freddie Mac.

Certain FHA program limitations and GSE conforming loan limit and other restrictions would need to be temporarily eased for SAFE loans. New eligibility criteria based on maximum loan-to-value and debt-to-income ratios would circumscribe the available SAFE loans. GSE investment portfolio caps may need to be temporarily eased to the extent of the SAFE loans purchased and held. In addition, the portfolio of new SAFE loans will require credit enhancements. In the case of FHA-lenders, FHA already provides credit insurance, and Ginnie Mae already provides guarantees. Treasury's FFB could provide backstop credit enhancements for other SAFE loans, for which Treasury would charge a guarantee fee.

While important details would need to be worked out regarding the SAFE loan plan, one should be able to rely on existing government agencies, mortgage market institutions, delivery systems, and instruments. In this manner, implementation could occur relatively quickly, in comparison to models relying on creating a new institution. Moreover, the SAFE loan plan would contain a shut-off valve that ended the program once market confidence and liquidity are restored. I and the other members of the team working with the Center for American Progress would be pleased to continue to work with all of you and your staff to develop these proposals in the weeks ahead.

Range of Responses Needed

Along with the SAFE loan plan, Congress ought to enact a range of complementary policies to address the housing crisis. As my fellow panelists will discuss in more detail, judicially supervised modifications of home mortgages should be permissible under certain narrow circumstances. Moreover, with significant foreclosures comes concentrated, local economic harm, including depressed property values, abandoned buildings, and crime. Congress should help hard-hit states and localities with additional, timely funding for Community Development Block Grants and HOME funds, as well as state and local aid to deal with abandoned and foreclosed properties, as outlined by CAP, NHS, and Enterprise, and discussed by my fellow panelist Doris Koo.

Moreover, we need to fill what my friend, the late Federal Reserve Governor Ned Gramlich aptly termed, "the giant hole in the supervisory safety net."[6] We should take this opportunity to implement common sense reforms to the mortgage market, to reduce the likelihood of such a crisis in the future. In the Senate, Chairman Dodd and Senator Schumer and others have introduced important legislation to clean up the mortgage

[6] Edward M. Gramlich, "Booms and Busts: The Case of Subprime Mortgages," Presented in Jackson Hole, Wyoming, Aug. 31, 2007.

process and regulate mortgage brokerage to drive out abuses. Such legislation should be enacted. In addition, the Federal Reserve Board's recent proposals to bar unfair and deceptive mortgage practices should be implemented immediately. Moreover, to increase transparency, all borrowers need to be able to get firm price quotes on loans and settlement services in order to comparison shop. We also need to increase public disclosure and regulatory monitoring of credit standards.

In addition, Harvard economist Sendhil Mullainathan, Princeton psychologist Eldar Shafir, and I have argued for a new, opt-out mortgage plan.[7] While the causes of the mortgage crisis are myriad, a central problem was that brokers and lenders offered loans that looked much less expensive than they really were, because of low initial monthly payments and hidden costly features. As Ned Gramlich asked, "Why are the most risky loan products sold to the least sophisticated borrowers?"[8] Many borrowers took out loans that they did not understand and could not afford, with predictable results.

In retirement policy, behavioral research has led Congress to promote "opt out" plans under which employers sign workers up for retirement benefits unless the worker chooses not to participate. This policy has significantly improved people's retirement savings. Under an opt-out home mortgage plan, borrowers would be offered a standard set of mortgages, with sound underwriting and straightforward terms. And that's the mortgage they'd get, unless they opted out. An opt-out system would mean borrowers would be more likely to get straightforward loans they could understand, without blocking beneficial financial innovation.

Conclusion

Let me conclude by saying that there are undoubtedly risks to this approach. The federal government would end up bearing some residual risk, and there are potential problems of adverse selection and moral hazard. There are also concerns of equity, as some homeowners will be helped, while other homeowners will be left to pay their loans in full. There are steps one can and should take to mitigate these concerns, some of which I have outlined above, but they cannot be fully eliminated in any program.

On the other side must be balanced the risks of doing nothing, with mounting foreclosures and a serious credit crunch further depressing the economy and causing widespread harm to families, communities, and our national economy. Our financial markets are currently unable to get us out of this crisis, and the consequences are getting worse every day. If we do not take the steps today to facilitate the private market restructuring these loans and restoring liquidity and confidence, we risk finding ourselves in six or nine months with a crisis so severe that the best option available is direct government intervention. While the question is not without difficulty, in my judgment the risks of the proposal are significantly outweighed by the risks of failing to act.

Stabilizing housing markets will be crucial to working through excess housing inventory and setting the economy on a road to normalcy. As Treasury Secretary Henry Paulson has stated: "The overhang of unsold houses will contribute to a prolonged adjustment, and poses by far the biggest downside risk [to the economy]."

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[7] For details of the opt-out mortgage proposal, see Michael S. Barr, Sendhil Mullainathan and Eldar Shafir, "Behaviorally Informed Home Mortgage Regulation," Joint Center on Housing Studies, 2007.

[8] Gramlich, op. cit.

The SAFE loan plan can help to restore confidence and liquidity in our housing finance markets. It could help to keep responsible borrowers in their homes. And it could help to end the vicious cycle of defaults, foreclosures, credit tightening, and contagion to other markets, which have put us at a real risk of sustained recession or stagnation if we fail to act.

We have a shared responsibility for setting things right, and thanks to the leadership of Chairman Dodd, Ranking Member Shelby, and the distinguished members of this Committee, we have a shared opportunity to act swiftly, decisively, and wisely, to help American families through these trying economic times.

Appendix A

Proposal Team

- **David Abromowitz**- Partner, Goulston & Storrs and Senior Fellow, CAP. Abromowitz is a past chair and founding member of both the Lawyers' Clearinghouse on Affordable Housing and Homelessness and of the American Bar Association's Forum Committee on Affordable Housing and Community Development. 25 years experience in housing transactions and policy.

- **Andrew Jakabovics**- Associate Director for the Economic Mobility Team, CAP. Jakabovics holds a B.A. in Urban Studies from Columbia University and an Masters of City Planning from MIT, where he is currently pursuing his doctorate in the Department of Urban Studies and Planning.

- **Michael Barr**- Professor of Law, University of Michigan Law School and Senior Fellow, CAP. Barr previously served as Treasury Secretary Robert E. Rubin's Special Assistant and as Deputy Assistant Secretary of the Treasury for Community Development Policy. Barr conducts large-scale empirical research regarding low- and moderate-income households, including as the Principal Investigator for the Detroit Area Household Financial Services Study at the Survey Research Center of the University of Michigan, and as a key researcher for the FDIC's study of bank services for LMI households.

- **Ellen Seidman**- Director, Financial Services and Education Project, Asset Building Program, New America Foundation and EVP, National Policy and Partnership Development, ShoreBank Corporation. From 1997 to 2001, Seidman was Director of the U.S Treasury Department's Office of Thrift Supervision and served as Special Assistant for Economic Policy to President Clinton. She has also held senior positions at Fannie Mae, the United States Treasury Department, and the United States Department of Transportation.

- **Laura Tyson**- Professor of Business Administration and Economics, Haas School of Business, University of California at Berkeley and Former Dean, London Business School and Haas School of Business. Dr. Tyson served in the Clinton administration and was the Chair of The Council of Economic Advisors between 1993 and 1995, and she served as the President's National Economic Adviser between 1995 and 1996.

- **Susan Wachter**- Professor of Financial Management; Professor of Real Estate, Finance and City and Regional Planning, Wharton School of Business, University of Pennsylvania. Wachter has held many corporate and public sector leadership positions including; Academic Fellow, Urban Land Institute, 2003-2004; Advisory Board for Regulatory Research, National Association of Homebuilders, 2005-2006; Board of Directors, American Real Estate and Urban Economics

Association, 2003-2006; and Blue Ribbon Committee on Housing Finance, 2005-2006

- **Sarah Rosen Wartell**- Executive Vice President, CAP. During the Clinton Administration, Wartell served as Deputy Assistant to the President for Economic Policy and Deputy Director of the National Economic Council. Prior to serving at the White House, Sarah was a Deputy Assistant Secretary at the Federal Housing Administration in the Department of Housing and Urban Development.