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To the

U.S. Senate Subcommittee on Housing, Transportation and Community Development

Topic— Strengthening the Housing Market and Minimizing Losses to Taxpayers

Chairman Menendez and Members of the Subcommittee, I thank you for your invitation to testify today. My name is Laurie Goodman, and I am a Senior Managing Director at Amherst Securities Group, LP, a leading broker/dealer specializing in the trading of residential and commercial mortgage-backed securities. We are a market maker and intermediary in these securities, dealing with many of the largest financial institutions, insurance companies, money managers and hedge funds. I am in charge of the Strategy effort, which performs extensive, data-intensive studies as part of our efforts to keep ourselves and our customers informed of critical trends in the residential mortgage-backed securities market.

In my testimony today, I will discuss three actions that can strengthen the mortgage market, at no or minimal cost to taxpayers: ***increasing reliance on principal reduction modifications; a ramp up of the bulk sales program, coupled with financing for these properties; and a careful vetting of new rules that affect already tight credit availability.***

Sizing the Challenge

As we look across the U.S. housing landscape, our empirical studies have convinced us that there are a huge number of borrowers (7.4 – 9.3 million) yet to face foreclosure and eventual liquidation. The expected liquidations break down into the following categories:

3.5 – 4.0 million borrowers already 60+ days past due on loans (many seriously past due)

+

1.5 – 2.0 million borrowers with a compromised mortgage payment history (used to be 60+ past due, now not)

+

2.4 – 3.3 million borrowers with excellent payment history, but underwater (owe more than value of home)

EQUALS

7.4 – 9.3 million borrowers yet to face foreclosure/liquidation

Thus, if we stay on the present course, of the 52.5 million total U.S. homes with a mortgage, 14.1–17.7%, or 7.4 – 9.3 million of these borrowers face foreclosure and eventual liquidation. To absorb this large number of housing units that

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will face foreclosure and eventual liquidation, we need to both ***limit the supply of AND increase the demand for distressed properties***. To *limit supply*, we need more successful loan modifications. For this, we believe increased reliance on principal reduction is the key. To *increase demand*, we need a successful bulk sales program to bring institutional investors into the housing market. We also need broader credit availability standards, yet every single governmental action that is being considered seems to further constrain credit availability.

Most of my testimony will be focused on *supply side* measures; namely, improving modification success through greater reliance on principal reductions. Then I will take up *demand side* measures. I will touch upon the new government program to sell single family properties to investors (for turning into rental units; a program we believe will be ultimately very successful). Finally, I will delve into the negative impact of constrained credit availability, and my concern about impending regulations that will exacerbate this issue. ***All of my recommendations in this testimony (expanded use of principal reductions, the bulk sales program, and fully vetting the impact of new rules or guidelines that affect credit availability) require very limited use of taxpayer money.***

Why Investors Support Modification Activity

Modification success has improved dramatically over time. In private label (non-agency residential mortgage) securitizations, for modifications performed during the first half of 2011, the average re-default rate after 12 months is down to 30%, versus 70% performed during the first half of 2009. The improved results reflect two factors: 1) the way modifications are counted has changed, which has improved reported success rates, and 2) modifications have become much more significant, increasing the appeal to borrowers remaining in the home. This has genuinely improved success rates.

- 1) *Change in modification count methodology*—There was no trial period for modifications completed in early 2009 and earlier. The modification was “counted” the minute it was initiated, yet many modifications failed in the first 3 months, which boosted the failure rate of those early modifications. The trial period was introduced as part of the HAMP program, and was quickly adopted for proprietary modifications.
- 2) *Modifications have become more significant over time*—The HAMP modification program has been important in that it provided a blueprint for significant pay relief for the borrower. And modifications that provide more significant relief have resulted in much lower re-default rates than earlier modifications that did not.

It's the investors in private label securitizations who bear the cost of any modification on those securities, be it a principal reduction or an interest rate decrease. However, investors in private label securitizations have been very supportive of modification efforts. *Why?* Investors recognize that foreclosure is both the worst outcome for the borrower **AND** the investor. A simple example in Exhibit 1 (next page) makes this argument concrete. The data in the exhibit are real, drawn from the universe of private label securities that were liquidated in the past month. The average loan balance is \$279,184, but if we marked these homes to market, the current market value of the homes averaged only \$227,046 (thus “underwater” with a loan-to-value ratio of 123%) due to price depreciations on the properties. If the property were liquidated the investor would not realize that market value of \$227,046, since homes in foreclosure usually sell at a discount. The investors should have realized a gross recovery, net of broker commission, on the property of \$173,591 (amounting to a 62.2% of the current loan balance, or 76% of current market value). Furthermore, there are other costs to subtract from the sale proceeds due the investor, arising from the borrower having been, on average, 26 months delinquent at liquidation. These costs are sizeable; advances for tax and insurance total \$21,927 and other direct costs associated with foreclosure and liquidations total \$7,452. Finally, every day a house remains in non-performing status, with either a homeowner who is not maintaining the property, or the home sitting vacant—the property is deteriorating. We estimate that the deterioration factor decreases property value by another \$13,842 over the 26-month average

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Exhibit 1: Variables Driving Loss Severity

	Liability	Asset	% of UPB
Current Loan Balance	\$ 279,184		100.0%
Gross Recovery		\$ 173,591	62.2%
Tax	\$ 14,084		5.0%
Insurance	\$ 7,843		2.8%
Other Monthly Cost	\$ 13,842		5.0%
Foreclosure Cost	\$ 2,452		0.9%
Fixed Cost of Liquidation	\$ 5,000		1.8%
	\$ 322,405	\$ 173,591	
Loss/Severity		\$ 148,814	53.3%
Net Recovery		\$ 130,370	46.7%

Original Purchase Price	\$ 360,000
Current Market Value of Home	\$ 227,046
Home Price Depreciation	-37%
Original LTV	77
Current LTV	123
DQ Months	26
P&I for PLS Loans	\$ 30,800

Legend: UPB = Unpaid Principal Balance; LTV=Loan-To-Value; DQ=Delinquent; P&I=Principal and Interest; PLS=Private Label Securities

Source: CoreLogic 1010data, Amherst Securities as of February 2012

period of delinquency. These costs are all captured in Exhibit 1. Note that collectively an investor nets \$130,370 (\$173,591– \$43,221), for a 46.7% net recovery (or a 53.3% loss per loan balance). The recovery to the investor in private label securitizations will be even lower, because, upon the liquidation of the trust, the servicer will be reimbursed for any payments of delinquent principal and interest that he has made to the trust.

An investor would be far better off if a substantial payment reduction had been offered to the borrower, to reduce the loan payment to an affordable level, rather than going through foreclosure and liquidation (and the investor ending up with only 46.7% of the loan being repaid). If the borrower were offered a principal reduction to 100% of the current market value of the home (\$227,046) and was able to make the payments associated with this loan, both the borrower and the investor would be much better off. The investor now has a loan worth \$227,046 rather than \$130,370.

My representation that investors are in favor of modifications is not to say that there is no room for improvement—there is. Here are some of the most important weaknesses from the point of view of investors:

- Servicers are in charge of performing the modification. But they are massively conflicted, as they often own the *second* lien on the same property, but service *both* the *first* lien and the *second* lien. We believe that special servicers, who specialize in dealing with non-performing loans, are apt to demonstrate a track record for better modification success, as: 1) they are not in a position of conflict; and 2) they can review the full range of alternatives in order to maximize the value of the loan, not just whether a given modification is better than foreclosure (which sets a low bar for a standard of delivering final proceeds to settle a loan, as illustrated above).

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- A modification considering the borrower's total debt situation (including second liens, credit cards, auto loans, etc. , which are often collectively referred to as "back-end debt-to-income ratio") will be more successful than one only considering the payments on the first lien, plus taxes and insurance (the "front-end debt-to-income ratio"). In fact, we believe the best way to have structured the modification program was to re-underwrite the loan for sustainability, while respecting lien priority. In many cases, this means the second lien would be written off entirely, and the first lien would be resized. In a more optimal world other debts would also be resized.
- Re-equifying the borrower is critical. Borrowers who are deeply underwater are less likely to commit to a successful modification. This suggests that principal reductions should be more effective than other types of modifications (rate modifications or capitalization modifications) — and they are proving to be so.

It is important to take a step back and outline the three basic modification types: *principal balance* modifications, *rate* modifications, and *capitalization* modifications. In a principal modification, the principal balance is reduced. This can take the form of principal *forbearance* (deferral), in which the borrower still owes the money, but does not pay interest on it, and principal *forgiveness*, in which the borrower does not owe the money. In a rate modification, the interest rate is reduced. In a capitalization modification, neither the interest rate nor the principal balance is reduced, but the term may be extended to reduce the payment.

Principal Reduction Is the Most Effective Form Of Modification

It has become increasingly common to modify principal balances rather than just modifying the rate and term on a mortgage. For example, in 2009 for private label securities, only 5% of modifications were principal modifications, whereas now a full 32% are. The reason is that this is the most effective type of modification.

While available data on private label securities does not allow us to distinguish forgiveness from forbearance modifications, the OCC/OTS report¹ does. It provides some very interesting numbers, based on information reported by the largest servicers. The data shows the types of modifications that were received, sorted by the bearer of the risk. Note that each column adds to more than 100%, as more than one type of action is generally taken in a modification. Thus, a servicer may recapitalize delinquent balances, reduce the rate, and extend the term (length to maturity) of the loan. Or— they may recapitalize the delinquent balances, and forgive (reduce) the balance or forbear (defer) the principal.

Look first at the data from Q4 2010 (left side, Exhibit 2, next page). Note that banks were doing principal reduction solely for their own portfolio (17.8% of banks' own portfolio loans received a reduction), but few loans serviced by the banks for others received principal reductions. By Q3 2011 (the most recent data available, shown on the right side of Exhibit 2), banks were doing principal reduction both for their own portfolio (18.4% of the loans) as well as for loans serviced on behalf of private label investors (15.3% of the loans). Note that the share that received reduction on loans insured by Fannie Mae, Freddie Mac or the U.S. government is zero, as servicers are not permitted to do principal reduction on these loans. The bottom part of the table in Exhibit 2 shows that the success rate on banks' portfolio loans is better than that on loans serviced for others. We would really like to know the success rate on principal reduction modifications versus other types of modifications (controlling for other characteristics, of course) but this information is not disclosed.

¹ OCC Mortgage Metrics Report—Third Quarter 2011, Office of the Comptroller of the Currency/Office of Thrift Supervision, dated 12/21/2011

Exhibit 2: Principal Reduction — Banks Doing It For Their Own Portfolio (And It Works!)

Percentages of Each Type of Modification by Investor in Fourth Quarter 2010							Percentages of Each Type of Modification by Investor in Third Quarter 2011						
	Fannie Mae	Freddie Mac	Government-Guaranteed	Private Investor	Portfolio	Overall		Fannie Mae	Freddie Mac	Government-Guaranteed	Private Investor	Portfolio	Overall
Capitalization	98.6%	98.6%	99.4%	79.2%	73.9%	91.6%	Capitalization	96.8%	99.1%	98.3%	85.3%	67.4%	88.5%
Rate Reduction	78.6%	70.4%	98.2%	86.2%	85.1%	84.1%	Rate Reduction	70.4%	74.0%	93.7%	71.5%	83.6%	77.5%
Rate Freeze	3.5%	5.4%	0.2%	1.4%	2.2%	2.4%	Rate Freeze	3.6%	7.6%	0.8%	5.8%	5.6%	4.6%
Term Extension	49.2%	71.6%	81.0%	36.6%	49.1%	56.1%	Term Extension	68.1%	69.5%	84.4%	24.2%	63.5%	57.8%
Principal Reduction	0.0%	0.0%	0.0%	1.8%	17.8%	2.7%	Principal Reduction	0.0%	0.0%	0.0%	15.3%	18.4%	7.8%
Principal Deferral	7.9%	11.6%	0.4%	13.5%	16.3%	9.0%	Principal Deferral	25.6%	18.2%	0.1%	23.0%	29.2%	20.5%
Unknown	0.3%	0.2%	0.1%	1.5%	5.6%	1.2%	Unknown	0.6%	0.2%	0.7%	1.7%	1.2%	1.0%

Re-Default Rates for Portfolio Loans and Loans Serviced for Others (60 or More Days Delinquent)*				
Investor Loan Type	Three Months After Modification	Six Months After Modification	Nine Months After Modification	12 Months After Modification
Fannie Mae	12.1%	19.4%	24.5%	28.8%
Freddie Mac	11.7%	18.9%	24.3%	28.2%
Government- Guaranteed	17.4%	34.9%	45.0%	50.8%
Private	24.3%	35.7%	43.0%	48.3%
Portfolio Loans	8.0%	15.6%	21.4%	25.2%
Total	16.2%	26.7%	33.6%	38.5%

* Data include all modifications implemented since January 1, 2008, that have had time to age the indicated number of months.

Source: OCC Mortgage Metrics Report – Fourth Quarter 2010, Third Quarter 2011

Moreover, our discussions with individual servicers show that they are increasingly relying on principal forgiveness. Under HAMP, servicers are required to test a borrower for a modification using the regular HAMP waterfall (first reduce the interest rate, then extend the term, then forbear principal) and the principal reduction alternative (first forgive principal, then reduce the interest rate, then extend the term, then forbear principal). However, if the principal reduction alternative has a higher net present value (NPV) they are not required to use it. In May 2011, Bank of America announced that when the NPV test showed the superiority of the principal reduction alternative, they will start using it. And we see that the number of Bank of America serviced loans receiving principal modifications is up sharply since then. We also see large increases in the number of principal modifications on Chase- and Ocwen-serviced loans.

At Amherst, we have done extensive empirical work and shown that there are 3 determinants of modification success:

1. The amount of pay relief is important.
2. The number of months delinquent at the time of modification is quite important. If you offer a borrower a modification with 30% pay relief at the point when the loan is 2 months delinquent, the borrower is apt to regard that as a terrific deal. But that same modification offered to a borrower who is 12 months delinquent is apt to be regarded as a huge increase over the then-present (defaulted) payment of “zero.” We were pleased to see changes in the HAMP incentive structure to encourage earlier modifications.
3. **Finally, we found that principal modifications (as opposed to interest rate or capitalization modifications) have the highest success rate, even controlling for these 2 first factors.**

We at Amherst are not the only market participants who have discovered that principal modifications have a higher success rate than other types of modifications. A study² by Moody’s Investor Services looked at modification success by

² “Principal Reduction Helps to Reduce Re-Default Rates in the Long Run,” Moodys ResiLandscape, Moodys Investor Service, dated 1/20/2012

LTV (loan-to-value) bucket (a group of loans grouped along similar characteristics), and showed that loans with lower LTVs have higher modification success. Most importantly, they showed that the difference in modification success between loans grouped by LTV buckets becomes more pronounced over time. That is, the difference between LTV buckets is much greater after 18 months than it is after 6 months from modification. Clearly, principal reduction will reduce the LTV on the loans, whereas other types of modifications will not. In further studies at Amherst, we have independently come to the same conclusion.

We very much like the construction of the principal reduction alternative under HAMP. It is done as “earned forgiveness”; the principal is initially forborne, and 1/3rd is forgiven per year, but only as the borrower continues to make on-time payments. We believe this is a very important feature for a principal reduction program. Moreover, the recent tripling of the HAMP incentives under the principal reduction alternative, with the incentive going to the owner of the risk (the lender), should further spur the use of this alternative. We applaud the Treasury for taking this action.

The moral hazard issue is the single largest mental obstacle many market participants face when thinking about principal reductions. *Will performing borrowers intentionally go delinquent in order to get a principal reduction?* We have two responses to this. *First*, the moral hazard issue is present even under the present program. In fact, while we believe a successful modification program is essential to restore a healthy housing market, no modification program can be designed to completely eliminate moral hazard. *Second*, you can structure the principal reduction to minimize the moral hazard issue.

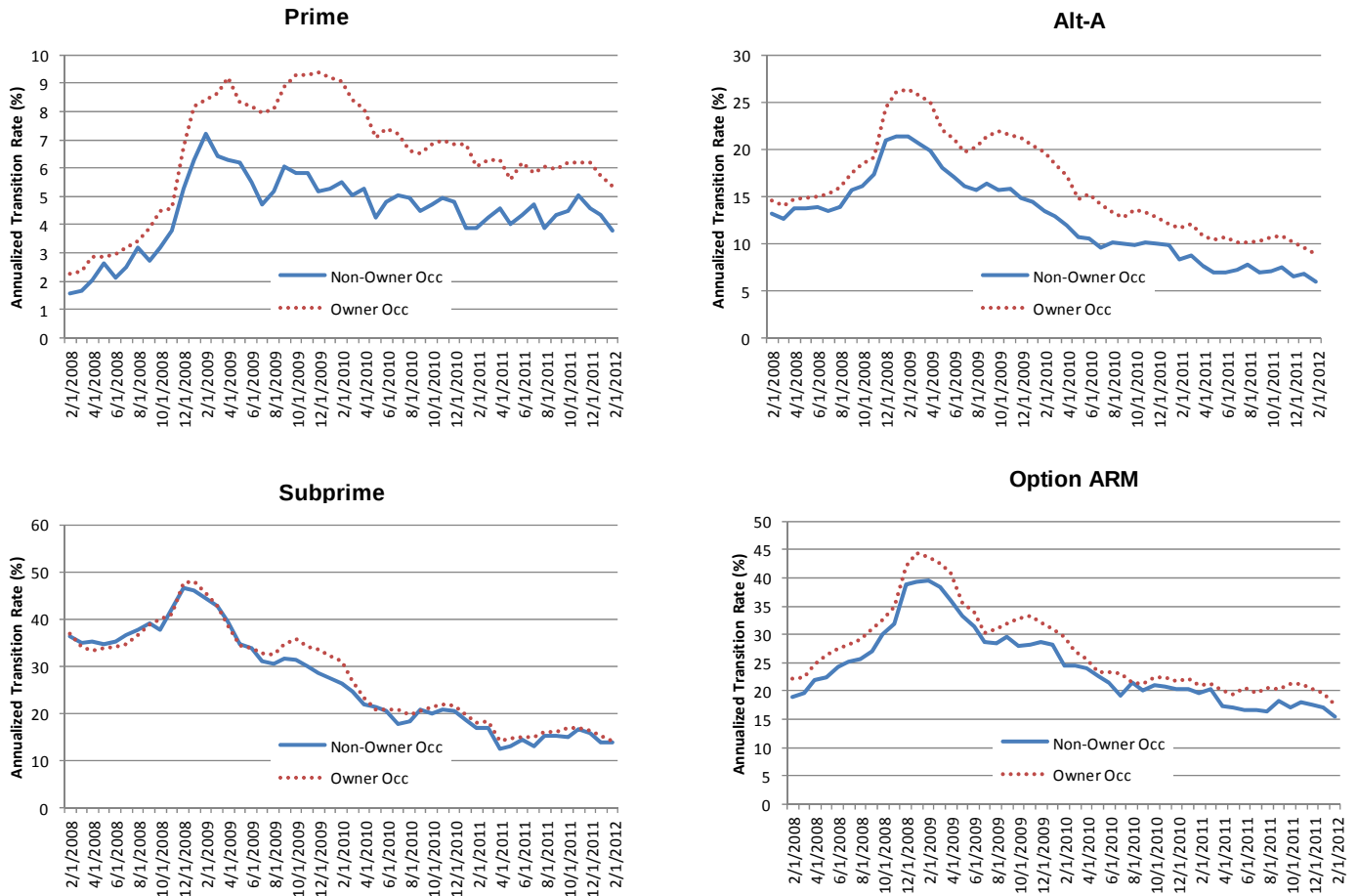
In order to show that moral hazard exists under the present program, look at Exhibit 3 (next page). We divided the universe of private label securities between owner-occupied borrowers and non-owner occupied borrowers, as only owner-occupied borrowers were eligible for the HAMP modification program, which started in early 2009³. We have confined our work to the private label securities universe, as we have very good payment information about these loans. Exhibit 3 shows the rate at which performing borrowers are going 2 payments behind for the first time; this is referred to as the “default transition rate.” Note that for borrowers whose loans are considered “Prime” and “Alt-A,” the default transition rate between owner-occupied and non-owner-occupied borrowers diverged significantly around the time the HAMP program was announced, as borrowers believed it was necessary to be 2 payments behind to receive a modification. **BOTTOM LINE**—Under the present program, some borrowers have clearly gone delinquent in order to qualify for a modification.

It is possible to structure a principal reduction program to minimize the moral hazard issue (that is, to counter the incentive that otherwise healthy borrowers have to default on their loan to obtain a modification). There are several ways to do that. The first is to require that the borrower already be delinquent at the start of the program, so borrowers are unable to plan to go delinquent to obtain the modification. Secondly, a shared appreciation feature can be offered. If a borrower accepts a principal write-down modification, the lender is entitled to some share of future appreciation. For the borrower whose loan is at 120 LTV—a write-down to 110 or 115% LTV along with giving up some percent of the upside will look unattractive. But for a borrower at 150 LTV, who is far more likely to default, this will appear very attractive. Senator Menendez, I know shared appreciation is an idea you have championed.

While we are huge fans of principal reduction, we are concerned about the moral hazard issue for both the borrower and the servicer. We have just discussed how it can be mitigated for the borrower. We are also concerned about the recent

³ On March 9, 2012, under HAMP Supplemental Directive 12-02, HAMP eligibility was extended to investors. However, this was not a consideration for the period covered in Exhibit 3.

Exhibit 3: Transition Rates (cTr) — 2004-2007 Vintages (by Occupancy, as % of Always Performing)



Strategic defaults appear to be happening in Owner-Occupied Prime and Alt-A

Source: CoreLogic, 1010Data, Amherst Securities

Attorneys' General Settlement allowing servicers to do "abusive" modifications in order to get "credit." We applaud the use of principal reductions on loans in a bank/servicer's own portfolio to meet these credits. But we have a problem with spending investor dollars to meet a penalty which was the result of sloppy foreclosure practices on the part of the servicer.

The GSEs and Principal Reduction

We were very pleased to see that under the Obama plan, incentive payments for principal reduction are now being offered to the GSEs. Prior to this (as Exhibit 2 has shown), the GSEs (and FHFA as their regulator) have been reluctant to approve principal forgiveness modifications, as they believe it is not NPV-positive to their agencies, and is hence inconsistent with the idea of conservatorship.

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FHFA Chairman DeMarco recently responded⁴ to a request from the House Committee on Oversight and Government Affairs to look at whether principal forgiveness on GSE loans would serve the interests of the taxpayer. That letter contained the results of the FHFA study (“FHFA Analysis of Principal Forgiveness Loan Modifications”) that compared losses to the GSEs from principal forgiveness versus principal forbearance, using the HAMP NPV model. They found that the losses were very similar.

We have three major criticisms of the methodology used for in the FHFA study:

First—A hypothetical model (the Treasury NPV Model) was used for the analysis, and there was no effort to look at actual HAMP results. Actual results (not hypothetical ones) should clearly be used where the data are available. If I am testing a new medical drug and have actual data on effectiveness in humans, I would clearly use that rather than data on theoretical effectiveness. And in this case, the data are available. The Principal Reduction Alternative under HAMP went into effect in October 2010. This suggests that the HAMP program has 16 months of data which can be used to measure the success of the Principal Reduction Alternative (the forgiveness program) versus the standard HAMP waterfall (which reduces the interest rate, extends the term, and forbears principal if necessary). **These actual HAMP results should have been examined.**

Second—There were four serious technical issues in the conduct of the study, which made principal forgiveness less appealing

- a) State level price indices were used, not MSA level indices. Thus, the FHFA picked up fewer high LTV borrowers than there actually are. These high LTV borrowers are aided more by principal forgiveness than their lower LTV counterparts.
- b) The results were done on a portfolio level, not an individual loan level. Thus, the FHFA did not consider the possibility of following a forgiveness strategy for some borrowers and a forbearance strategy for others. This would have clearly dominated the use of a single strategy.
- c) The actual HAMP program was not evaluated. The principal forgiveness in the HAMP program is the lesser of (the current LTV -- the target LTV) or 31 debt-to-income. The FHFA automatically assumed principal reduction equal to (the current LTV -- the target LTV). Thus, they overstated the amount of principal reduction that would have been granted for higher income borrowers. (For these higher income borrowers, the 31 DTI target would have required less forgiveness.)
- d) Attributes of the loan at origination, not current attributes, were used for the analysis. Delinquent borrowers, on average, have suffered a deterioration in FICO scores. By using origination characteristics, the health of the borrower is overstated, hence the assumed likelihood of success is too high. This overstates the cost of forgiveness.

Third—The FHFA study did not consider any differentiation between loans with mortgage insurance versus loans without it. If the overall result for the GSE book of business were very similar for forgiveness versus forbearance, forgiveness on loans *with* mortgage insurance should be more NPV-negative to the GSEs than would be forbearance, and forgiveness on loans *without* mortgage insurance should be more NPV-positive than forbearance.

⁴ FHFA letter to The Honorable Elijah E. Cummings, Ranking Member, Committee on Oversight and Government Reform, January 20, 2012

The mortgage insurance point is critical. Roughly 32% of the GSE portfolio of seriously delinquent loans carries mortgage insurance. If the GSEs do a principal write-down, they take the loss on loans irrespective of whether or not they have mortgage insurance. If the loan *with* mortgage insurance would otherwise (no modification or a different type of modification) have defaulted, the mortgage insurer would have paid the GSEs the coverage amount due. We'll use an example to make this clearer. Assume a borrower has a \$100,000 loan, on a house worth \$75,000. The GSEs have mortgage insurance from a mortgage insurer, which covers any loss down to \$70,000⁵. Assume that the borrower defaults, and the GSE offers the borrower \$20,000 of principal reduction, which reduces the loan balance to \$80,000, and gives the loan a 75% chance of eventual success. If the loan does not re-default (there's a 75% chance of that happening), the GSE loses the \$20,000 principal amount they gave up. But if the loan re-defaults and the house then sells for \$70,000 (25% chance), the mortgage insurance pays \$10,000 to the GSE for the lost principal, in which case the GSE still loses \$20,000. If principal is forborne, and the borrower defaults, the mortgage insurer would cover the loss. So when there is mortgage insurance, it is generally not NPV-positive to the GSEs to do principal forgiveness— forbearance creates the preferred outcome, as the MI does not cover the forgiven amount.

For loans without mortgage insurance, it is generally NPV-positive to the GSEs to do principal forgiveness. Let's assume the same defaulting borrower as above. The borrower achieves the same payment relief under the standard HAMP waterfall and under the principal reduction alternative, so the NPV of the cash flows will be very similar (the difference will be the discounted value of the forborne amount; and remember that the present value of \$20,000, 40 years from now, assuming a 5% interest rate, is approximately \$2800). However, the default rate will be lower on the forgiveness modification (as it will have a lower post-modification LTV), lowering any further loss as well as the expenses associated with that loss, thus making it the more attractive option for the GSEs.

And there is no question in my mind that forgiveness could be implemented for part of their book of business, without implementing it on the entire book of business. Precedence for this comes from the HARP program, where only loans issued before the June 1, 2009 cut-off date are eligible for a streamlined refinance.

We understand that the primary issue in the mind of the FHFA is that more than 90% of GSE loans are current, and FHFA is very concerned about the moral hazard issue. The fear is that principal write-downs encourage borrowers to default who otherwise would have stayed current. As we point out above, there are two easy solutions to the moral hazard issue. The first solution is to require that the borrower be delinquent as of a certain date, so performing borrowers do not intentionally go delinquent in order to get the principal reduction. The other choice is to establish a series of frictions so that only those borrowers who need the principal reduction take advantage of the program. This could involve the inclusion of a shared appreciation feature or other frictions to default.

We hope that new measures permitting the GSEs to be eligible for the principal reduction incentive payments would allow the FHFA to re-evaluate their stance on principal forgiveness. And the newly announced triple incentive payments will be incorporated in Version 5.0 of the Treasury NPV model. We would urge the FHFA to **re-run their results, using the new model which incorporates the triple incentives, correcting the technical flaws in their analysis, and breaking out loans with and without mortgage insurance separately. We believe when this is done, it will be clear that forgiveness is the better solution for the bulk of the 2/3 of their book of business without mortgage insurance.** Moreover, we believe that once the GSEs start doing principal forgiveness, the program will become even

⁵ In this case, the mortgage insurance covers the first \$30,000 in losses. It does not cover additional losses to the holder if the loan repays \$70,000 or less.

more widespread in PLS (private label securitizations), as servicers will make the investment in the technology to make it available for all delinquent loans.

Demand Side Action—Bulk Sales

I can't tell you how pleased we are to see the announcement of the Fannie Mae bulk sales pilot program. I testified before the Senate Committee on Housing, Transportation and Community Development last September on the need for bulk sales. The argument in favor of bulk sales is that there is a huge shadow inventory of homes that needs to be absorbed. Roughly 2.7 million borrowers have not made a payment on their home in over a year. Another 400,000 homes are in REO (the "real estate owned" category, which consists of troubled properties that have been re-possessed). Collectively, they constitute a shadow inventory of 3.1 million units. There isn't insufficient demand from owner-occupants to absorb this number of units. Thus many of these properties must transition to investors. Currently, some of the properties are transitioning to smaller investors, but, prior to this program, there was no mechanism for institutional investors to buy properties in bulk.

Buying in bulk is important to an institutional investor, as they want to put into place a professional property management organization and a rental organization, both staffed locally. If an institutional investor has only accumulated a few homes, it is difficult to justify the cost of building out the necessary service organizations. But if they are able to accumulate a large number of homes at once, it becomes economic to do so. It also suggests that institutional investors will pay a premium to accumulate the properties in bulk than one-by-one. We believe that both Fannie Mae and FHFA will be very pleased with the execution of the pilot program, and will choose to implement on a larger scale, by selling both non-performing loans and REO properties.

What about the argument that selling homes one-by-one is more profitable? We believe that will prove to be incorrect. *First*, institutional investors will pay a premium to accumulate in bulk. *Second*, when you sell homes individually, all the properties sell more slowly, plus many don't sell at all. Marketing costs are also higher. Consider the costs of a slower sale: tax and insurance payments still have to be kept current until the home is sold. Plus, the GSEs are either paying to maintain the property, or realizing a lower sales price because the condition of the home is deteriorating.

In the construction of this pilot program, we encourage the provision of financing. Currently, there is no mechanism for financing scattered site single home purchases of more than a small number of properties (Fannie will finance a maximum of 10 properties; Freddie a maximum of 4 properties). It makes little sense to have a cut-off based on the number of properties. Rather, very conservative financing should be provided—and by conservative, we mean at least 30% down payment. ***The provision of financing would be reflected in higher bids on the property. Hence, the financing would be a benefit to the taxpayers, not a cost.***

We believe that by giving institutional investors the ability to purchase homes in bulk, large amounts of shadow inventory can be absorbed. This will make substantial progress toward cleaning up the shadow inventory, which is critical to stabilizing home prices. Once home prices stabilize, the hope is that credit availability will increase.

Credit Availability Standards

There is currently a disconnect in the housing market between affordability and the level of housing activity. The National Association of Realtors Home Affordability Index is at its highest since they began tracking it in 1986. This Index measures the ability of the median family to purchase the median priced home, putting down 20% and taking out a 30-

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year fixed rate mortgage at prevailing interest rates. With the Case Shiller Home Price Index down 34% from the peak, and 30-year fixed rate mortgage rates at the lowest level they have been since the 1960s, it is not surprising that housing looks quite affordable. The real question is—*Why is the Mortgage Bankers' Association Index measuring purchase activity at a 15 year low? —why are existing home sales so low?*

The answer is that credit availability is very tight. Affordability based on median income is at an all-time high but, at the same time, the median family balance sheet cannot afford to put down 20% on a home purchase, nor can they qualify for a 30-year fixed rate mortgage at today's qualification standards. (And if a borrower wants to put down more less than 20% on a conventional loan, they will need either mortgage insurance or a second lien; both have become increasingly difficult to obtain.) In reaction to the extremely sloppy underwriting standards prevailing in the 2005–2007 period, the GSEs and bank originators have dramatically tightened origination standards. The average GSE origination for 2009–2011 has a 762 FICO, and a 68 LTV. The average bank portfolio loan has a 756 FICO, 67 LTV. Moreover, almost 20% of the 2007 borrowers have defaulted or gone more than 90 days delinquent on their existing loan, thus ruining their credit score and making them unable to buy another property.

Yes, lending standards were certainly too loose in the 2005–2007 period, but they are now too tight everywhere, with the exception of FHA/VA loans. And every single action that is being contemplated will actually make them tighter. One point of particular concern for us is the Qualified Mortgage (QM) Standards.

We expect the CFPB (Consumer Finance Protection Bureau) to finalize an ability-to-repay rule that does not contain a safe harbor from liability for lenders who make a QM (Qualified Mortgage) loan. Instead, preliminary discussions indicate the CFPB is most likely to provide lenders with a rebuttable presumption and establish a “bright line” test of what constitutes a QM loan. If a real “bright line” test is drawn, lenders might be comfortable doing QM loans even with a rebuttable presumption.

However, it will clearly crimp credit availability for all loan applications that do not clearly meet the “bright line,” and any ambiguity in the “bright line” will further crimp the market. Moreover, the greater the consideration of “compensating factors” which makes for more rational lending standards, the less “bright line” the QM test can be. For example, a 43% back-end DTI does not sound like an irrational limit; however a borrower with limited income and substantial assets with little of those assets in cash, who is putting down 40%, may not be able to take out a QM loan.

From a lender's point of view, the fear is that default is itself evidence of lack of ability to repay. The penalties for non-QM compliance are substantial. Moreover, for loans done outside of a safe-harbor and/or the “bright line” test—i.e., non-QM loans—lenders will be subject to Truth in Lending Act (TILA) litigation risks; it is reasonable to expect borrowers to commonly allege lack of ability-to-repay, and to seek TILA damages. Litigation is expensive—on average costing lenders about \$70,000–\$100,000 per loan—costs that far exceed the few thousand dollars that a lender might make on originating any one loan.

Some predict that there will be a vibrant market for non-QM loans, but that is not likely because of the liability associated with originating those loans. Suppose an investor were willing to purchase MBS backed by non-QM loans. If the non-QM borrower were to allege a lack of ability-to-repay, the investor could look to the originating lender for recovery, under the lender's representations and warranties that the loan met the ability-to-repay requirements. We expect that investors may be willing to buy MBS backed by non-QM loans originated by well-capitalized lenders, but those lenders may not be willing to make non-QM loans because the liability far exceeds the potential profit from loan origination. Lenders with limited capital may be willing to make non-QM loans, but those lenders will not be able to attract investors. There will be no ability to make higher cost loans to more risky borrowers.

We expect the ability-to-repay rule to further constrain mortgage credit under any circumstances. However, unless the final rule includes either a safe harbor and a “bright line” test or, at a minimum, a very clear “bright line” test in conjunction with the rebuttable presumption, the rule will limit the availability of mortgage credit.

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Conclusion

In my testimony today, I have discussed three actions that can strengthen the mortgage market, at no or minimal cost to taxpayers: ***increasing reliance on principal reduction modifications; a ramp up of the bulk sales program, coupled with financing for these properties; and a careful vetting of new rules that affect already tight credit availability.***

We urge Congress to do everything they can to facilitate these actions.

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