TESTIMONY OF CHRISTOPHER J. MAYER

JUDICIARY COMMITTEE OF THE UNITED STATES HOUSE OF REPRESENTATIVES

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Good afternoon. My name is Christopher Mayer. I am the Milstein Professor of Real Estate and Senior Vice Dean at Columbia Business School.

We are witnessing an unprecedented crisis. House prices are in a near free-fall. More than 2.2 million foreclosures were started last year. And things may get much worse. Over 4 million Americans are at least 60 days late on their mortgages. We must act promptly.

Bankruptcy cramdowns may seem appealing, but in fact would exacerbate the crisis. If just one in 12 existing homeowners decided to stop paying and pursue bankruptcy, we would have double the current delinquency rate and a catastrophe. This is not unprecedented; it has happened before with credit cards.

Proponents of bankruptcy reform argue that cramdowns will not cost taxpayers any money. This claim is simply not true. Taxpayers are on the hook for $5.6 trillion in mortgage guarantees from Fannie Mae, Freddie Mac and the FHA.

Taxpayers could lose tens or hundreds of billions with cramdowns in mortgage losses and money needed to stabilize banks.

Yet cramdowns are unnecessary. The government can freely modify 35 million of the 55 million outstanding mortgages it controls through Fannie, Freddie, and the FHA. Another 12 million mortgages are in the hands of private lenders, not just money center banks, but also community banks and credit unions. These lenders are now undertaking appreciable efforts to modify loans. And the Obama administration has promised to spend $50 to $100 billion to reduce foreclosures.

Bankruptcy reform would delay the process of restructuring mortgages, the same costly mistake that Japan made in the 1990s. 368 bankruptcy judges now handle an average of 2,630 cases each per year. The courts would have difficulty handling a dramatically increased caseload with the care necessary to successfully modify loans. Even with this caseload, two-thirds of Chapter 13 plans ultimately fail. The best private mortgage modification programs have much better success rates.

Given the choice, servicers might prefer bankruptcy to loan modification because the typical securitization agreement reimburses servicers for expenses incurred in any legal proceeding, but not for modifications.

Finally, cramdowns would surely raise the cost of future borrowing and make credit less available to disadvantaged borrowers.

Instead, I suggest a comprehensive, three-pronged solution to this crisis. First, Dean Glenn Hubbard and I propose that the government arrange for the GSEs to issue new mortgages at a rate that is 1.6 percent above the rate of the 10-year Treasury; as low as 4 percent today. This is not a subsidized rate, but what mortgage rates would be with normally functioning credit markets.

Our plan would stimulate as many as two million new home purchases and put a floor on house prices. Lower mortgage rates would also allow as many as 34 million Americans to refinance their mortgages, saving $425 per month, or $174 billion per year every year. This is like a large middle-class tax cut. Permanent reductions in mortgage payments would stimulate higher consumption growth than one-time tax reductions.

Next, Columbia Professors Edward Morrison, Tomasz Piskorski, and I have developed a new proposal to prevent needless foreclosures. Recent research shows that banks that manage their own mortgages are one-third less likely to pursue foreclosure than servicers of securitized mortgages. Securitized mortgages represent 15 percent of outstanding loans, but half of foreclosure starts.

We propose that servicers be paid an Incentive Fee equaling ten percent of mortgage payments up to $60 per month. This program aligns incentives between servicers and investors and makes modification the preferred solution. If a mortgage is ongoing, the servicer receives a monthly fee; if it goes to foreclosure, the servicer receives nothing.

Second, the federal government should eliminate all contractual restrictions on loan modification. Ambiguous provisions should be clarified via a "safe harbor" that insulates reasonable, good faith modifications from litigation if they increase returns to investors as a group.

Our proposal helps homeowners. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that exceed the foreclosure value of her home, the same standard as envisioned for cramdowns.

A third proposal deals with troublesome second mortgages. Under this plan, the government would offer second lienholders up to $1,500 to drop their claim if the first mortgage is modified. This plan would apply to all mortgages and could facilitate 1.4 million new modifications.

These proposals address the current crisis at a cost of $12.8 billion payable by TARP funds. Why risk cramdowns when more effective, quicker, and less costly solutions are available?