TESTIMONY OF DR. CHRISTOPHER J. MAYER
BEFORE THE HOUSE COMMITTEE ON THE JUDICIARY
HEARING: “H.R. 200, THE "HELPING FAMILIES SAVE THEIR HOMES IN BANKRUPTCY ACT OF 2009", AND H.R. 225, THE "EMERGENCY HOMEOWNERSHIP AND EQUITY PROTECTION ACT"
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Good morning Chairman Conyers, Ranking Member Smith, and Members of the Committee. Thank you for inviting me to speak today. My name is Christopher J. Mayer. I am the Paul Milstein Professor of Real Estate and Senior Vice Dean at Columbia Business School. I have spent the last 16 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.

Accelerating declines in the housing market and growing foreclosures are placing a serious strain on American households and economy. While it is crucial to deal with the broader economic crisis through a comprehensive stimulus package and tax cuts, the economy is unlikely to recover without addressing the housing crisis directly. More than two-thirds of all American households own their own home. Most homeowners have relatively modest stock and pension holdings; the bulk of their wealth is tied up in their home. As house prices keep falling, these households suffer increasing wealth declines, making them more likely to further retrench and cut spending. As well, the increasingly dire problems in the banking sector are first and foremost tied to housing declines and mortgage losses.

The fall in the housing market has been stunning and unprecedented. House prices dropped about 18 percent in the last year according to Case and Shiller/S&P, likely the largest national decline in prices since the Great Depression. This has led to crisis of foreclosures, with 2.25 million foreclosures started last year (Federal Reserve)[1] and the forecast of 1.7 million foreclosures started in 2009 (Credit Suisse Foreclosure Update)[2]. Foreclosures contribute to a further decline in house prices, deteriorating communities, and failing banks. Despite good intentions and appreciable effort, public policy to stem foreclosures has had limited success.

And the problem will likely get worse without prompt action. As of September 2008, there were more than 2.2 million vacant homes, 4 million vacant rental properties, and 4.5 million houses on the market, unsold. If we do not reduce this inventory, house prices will keep falling. The likelihood of growing foreclosures looks equally bleak. As of October 2008, sixty-

[1] http://www.federalreserve.gov/newsevents/speech/bernanke20081204a.htm

[2] http://www.nhc.org/Credit Suisse Update 04 Dec 08.doc

day delinquency rates exceeded thirty-three percent among the 2.8 million outstanding securitized subprime loans and seventeen percent among the 2.2 million securitized alt-A loans. Even worse, many securitized option ARMs will hit negative amortization limits between 2009 and 2011, resulting in rising payments and higher default rates.

I believe we must address the foreclosure crisis immediately for economic and humanitarian reasons. As I will address below, amending the Bankruptcy Code to permit cramdown of first mortgages would generate serious risks and many unintended consequences. Instead, I propose an immediate solution that would appreciably alleviate the current foreclosure crisis more quickly and at a reasonable cost. My solution involves three plans that would encourage as many as a million additional successful mortgage modifications, help remove second liens as a barrier to loan modification and refinancing, and put a floor on house price declines and save tens of millions of homeowners an average of $450 per month, every month. These plans in total would cost taxpayers around $12.8 billion and start to turn the crisis around.

It is crucial to address the foreclosure crisis in a manner that yields quick results and does not bankrupt taxpayers and our financial system. While proponents of bankruptcy reform tout the fact that it will not cost taxpayers any money, as I show below, this claim is not true. Taxpayers are at risk for trillions of dollars in mortgage guarantees from Fannie Mae, Freddie Mac and the FHA that could be extremely costly if mortgage cramdowns are allowed. In addition, taxpayers have sunk hundreds of billions in the banking system, a cost that would also rise with cramdowns. The Obama administration has promised to spend between $50 billion and $100 billion reducing foreclosures as part of the second $350 billion that was authorized under TARP. So the government has already committed a large sum of money to reduce foreclosures. Bankruptcy reform is not only unnecessary, but it would delay the process of stopping unnecessary foreclosures.

The Problems with Bankruptcy Reform

Moral Hazard Could Make the Situation Worse

While 4 million borrowers are 60 days or more delinquent, 51 million borrowers are current on their mortgages. We know that one-third or more of these borrowers owe more money on their mortgage than their house is worth, and thus meeting one of the new criteria to qualify for bankruptcy protection. For these borrowers, the financial benefits of bankruptcy protection become real and appealing once cramdown is possible. The option of bankruptcy might lead millions of additional borrowers to stop paying their mortgage.

Easier bankruptcy laws for credit cards have led to millions of bankruptcy filings. It would be a catastrophe if most borrowers get the idea that they do not have to pay their mortgages. While many commentators have downplayed this argument as scare tactics, it is not hard to envision late night TV advertisements informing homeowners that they no longer need to make their mortgage payments and yet they could still remain in their home.

Overwhelmed Judiciary may lead to Delayed Resolutions

Bankruptcy reform would likely delay the resolution of the crisis for years, especially if millions of borrowers file for Chapter 13 bankruptcy. Currently the federal judiciary has 368 bankruptcy judges.[3] During the 12-month period ending June 30, 2008, there were 967,831 bankruptcy filings.[4] Thus the average judge managed 2,630 bankruptcy filings in the past year, even without bankruptcy cramdowns. Now these judges would be asked to oversee a new process on potentially millions of additional filings.

One of the lessons we should have learned from Japan was that quick resolution of a financial crisis is far superior to a slow response. Our public policy goal should be to as quickly address the foreclosure crisis as quickly as possible. This means stepping up private efforts to modify loans as well as creating strong financial incentives and legal protections for servicers to work with borrowers. Our proposal, below, allows a much quicker resolution to the crisis than bankruptcy expansion would.

The Government and Motivated Lenders Already Control Most Mortgages

We do not need the bankruptcy courts to intervene in the foreclosure process. Most recent data show that taxpayers already control the fate of 35 million of the 55 million outstanding mortgages through Fannie Mae, Freddie Mac, and the FHA; nearly two-thirds of all mortgages.[5] So the government is now in a position to control the bulk of workouts without bankruptcy reform. Cramdowns would just delay this process. This also means that taxpayers would bear the bulk of all losses from cramdowns. Securitized lenders control another 8 million mortgages.[6] The remaining 12 million mortgages are presumably in the hands of private lenders, including not only the large money center banks, but also community banks and credit unions. These private banks are undertaking appreciable efforts to modify loans. It is really only the privately

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[3] The most recent data we could find are from Sept. 30, 2007, and appear in "Judicial Business of the United States Courts" by the Administrative Office of the U.S. Courts, available at http://www.uscourts.gov/judbus2007/contents.html. This publication reports that Congress has authorized the appointment of 352 bankruptcy judges. However, as of Sept. 30, 2007, there were 11 vacancies. In addition, 27 retired bankruptcy judges had been "recalled" to serve on a part-time or full-time basis. This means that there were (352-11)+27=368 judges handling bankruptcy cases as of Sept. 30, 2007.

[4] This statistic is reported by the Administrative Office of the U.S. Courts at http://www.uscourts.gov/bnkrpctystats/statistics.htm#calendar

[5] According to the Mortgage Bankers Association, there are about 55 million mortgages outstanding. Fannie Mae and Freddie Mac control 30.7 million as of Sept 30, 2008 (http://www.fhfa.gov/webfiles/406/FederalPropertyMgrReport11609.pdf). The Federal Housing Administration controls another 4.8 million (http://portal.hud.gov/portal/page?_pageid=73,1828027&_dad=portal&_schema=PORTAL).

[6] Authors calculations from data from Black Box Logic, LLC as of October, 2008.

securitized mortgages where modification efforts have been failing. Our proposal addresses these mortgages directly, as opposed to imposing a costly system on the taxpayers and the bulk of lenders and servicers who are already modifying mortgages.

Losses to Taxpayers and Lenders Could Be Enormous

Taxpayers have a very large exposure to bad mortgages and thus have the most at risk under cramdowns. Outstanding debt and mortgage guarantees from Freddie Mac and Fannie Mae represent more than $5 trillion. As well, the government has hundreds of billions of loans at risk that were originated by the Federal Housing Administration. The FDIC has many billions more at risk for loan guarantees through takeovers of Indy Mac, Washington Mutual, and other failed lenders. Similarly, the government has other guarantees for debt from loans to AIG, Citigroup, and now Bank of America. The Federal Reserve has risks from former Bear Stearns securities and many other securities it now holds as collateral. So the taxpayers bear by far the biggest risks from cramdowns.

Bankruptcy may be especially harmful for lenders who have come up with other alternatives that may be equally or even more successful in reducing unnecessary foreclosures, but are less expensive for lenders. Forbearance is one such an alternative. The FDIC/Indy Mac program provides for reductions in both interest rates and forbearance on principal payments.[7] The recently announced effort by JP Morgan/Chase uses a similar strategy of loan forbearance. Many of the Bank of America and Citigroup modifications to subprime loans involve interest rate reductions rather than principal reductions. Fannie Mae and Freddie Mac have rolled out their own programs that do not rely on principal write-downs.

Borrowers have little incentive to accept an offer from a lender of interest rate reductions or forbearance when they can go to court and have a judge cramdown their principal balance, leading to an eventual permanent reduction in the amount of money they owe on their mortgage. When house prices rise, as they eventually will, cramdowns eliminate the possibility that a lender will ever recover its losses on borrowing. Thus borrowers have incentives to hold out for a better deal than they are likely to be currently offered, potentially delaying the resolution of housing problems for years and raising costs to lenders and taxpayers.

Potential Harm to Consumers

Bankruptcy is no panacea for consumers. Around two-thirds of all Chapter 13 cases terminate prematurely (see Wenli Li), leaving the homeowner liable for her original mortgage debt and creditors in a much worse position relative to having addressed the problem at the time of the bankruptcy filing. Equally devastating, third-party servicers might find it more attractive to deal with a homeowner in bankruptcy than to attempt a loan modification outside of

[7] Forbearance reduces the amount of principal that a lender applies interest to when computing monthly mortgage payments.

bankruptcy. Proponents argue that bankruptcy reform would give borrowers a tool to fight back against servicers. Yet, the opposite might be the case. Servicers might prefer bankruptcy to loan modification for the same reason that servicers now prefer foreclosure to modification. Under most PSAs, servicers would likely be able to recover expenses incurred in connection with a homeowner's bankruptcy filing, just as they now recover expenses incurred in connection with a foreclosure. There is no reimbursement for costs incurred in performing a loan modification. This could result in millions of Chapter 13 bankruptcy filings that harm consumer credit and appreciably delay a resolution of the crisis.

One Size-Fits-All Approach to Mortgage Modification

Bankruptcy reform applies a one-size-fits-all approach to all mortgages. But different modification strategies may be appropriate for homeowners with different incomes and credit scores. Lenders and servicers have discovered this, especially during the past several months, as they have experimented with new strategies for minimizing losses to investors and default by homeowners. Bankruptcy reform would inhibit this kind of experimentation. Proposed legislation[8] would invoke a standard set of modifications—reducing principal to current market value, reducing interest to the rate on conventional mortgages plus a reasonable risk premium, and extending the duration of the loan.

Higher Cost of Future Credit

Finally, empirical evidence suggests that if mortgages are subject to strip-down in bankruptcy, the cost of future credit will rise as lenders incorporate this new risk into their lending decisions. Future mortgage amounts will be smaller and borrowing costs will be higher. While many would argue that cheap and easy credit was what got us into this economic crisis, lenders are likely to raise the cost of borrowing already as a result of this crisis. Bankruptcy reform would increase borrowing costs further, resulting in even less borrowing and likely further reduce demand for housing. While we do not want overly subsidized credit, we want mortgages to reflect the true costs of borrowing and do not want to raise the costs of making mortgages to inefficiently deter future lending.

Alternative Approaches to Reducing Foreclosures

Instead of bankruptcy reform, I am here to suggest a three-pronged approach to stabilizing the housing market and preventing foreclosures. First, I address a new proposal prepared with Professor Edward Morrison of Columbia Law School and Professor Tomasz Piskorski of Columbia Business School to reduce foreclosures through a combination of an

[8] See House Bill H.R. 200, the "Helping Families Save Their Homes in Bankruptcy Act of 2009" and H.R. 225, the "Emergency Homeownership and Equity Protection Act".

incentive fee program to encourage servicers to avoid foreclosures and a legislative initiative to modify servicing agreements to clarify that servicers have the right to modify any loan where modification makes better economic sense than foreclosure.[9] The cost of this proposal is incredibly modest compared to other proposals. We estimate that as many as one million foreclosures could be prevented at a cost of $10.7 billion that could be paid for by TARP funds.

A second proposal with these same co-authors addresses the problems created by second lien holders, who are currently slowing the process of modifying or refinancing primary mortgages. Our proposal uses financial incentives to encourage second lien holders to cooperate with efforts to modify primary mortgages. This proposal could facilitate about 1.4 million modifications that would reduce foreclosures at a cost of $2.1 billion from TARP funds.

Third, I address a proposal prepared with R. Glenn Hubbard, Dean of Columbia Business School. We believe the federal government should act immediately to reduce mortgage rates and stabilize the mortgage market. Lower mortgage rates represent the single best way to reduce foreclosures by stabilizing house prices. Academic studies show that falling house prices are the single strongest contributor to the growth in foreclosures. Lower mortgage rates could attract new homebuyers to absorb inventory and allow as many as 25 million existing homeowners to refinance their mortgages, saving about $450 per month. This would provide a fiscal stimulus of $175 billion PER YEAR. This plan is not a substitute for the currently considered $775 billion stimulus, but unlike that program, the stimulus from lower mortgage rates would require no new federal appropriations. The government could simply arrange for lower rates by issuing US Treasury securities to fund new mortgages.

A New Proposal to Reduce Foreclosures and Help Struggling Homeowners

Even if we stabilize the housing market, millions of Americans may lose their homes in the coming years because of the economic downturn, the resetting of mortgage rates, and the end of negative amortizing mortgages. It is essential for the government to take prompt action to help prevent this crisis.

I have developed a plan for prompt action. The proposal, co-authored with Professors Edward Morrison and Tomasz Piskorski of Columbia University, is attached to this testimony, along with supplemental cost-benefit calculations and constitutional analysis. In this proposal, we offer a new approach to foreclosure prevention. We focus on what has been the most intractable part of the foreclosure problem: the behavior of third-party servicers who manage

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[9] This proposal has been distributed to Committee Members and is available on my website along with other research on the housing and mortgage crisis at http://www4.gsb.columbia.edu/realestate/research/housingcrisis/mortgagemarket.

portfolios of securitized portfolios. Why focus on servicers of securitized mortgages? Because securitized subprime, alt-A, and prime/jumbo loans accounted for more than one-half of foreclosure starts in 2008 despite representing about fifteen percent of all outstanding mortgages.[10] While the Fannie Mae, Freddie Mac, the FHA, and the largest private banks and portfolio lenders have announced their own aggressive programs to pursue mortgage modification, servicers of securitized mortgages lag behind.

Our approach to combating foreclosures builds on research by Tomasz Piskorski, Amit Seru, and Vikrant Vig[11] showing that portfolio lenders—lenders who service loans that they own—are significantly more successful in stemming foreclosures than third-party servicers, who service loans owned by other parties. This research shows that portfolio lenders achieve foreclosure rates that are nineteen to thirty-three percent lower than the rates experienced by third-party servicers. In fact, portfolio lenders are even more successful in reducing foreclosures for the highest quality loans, where current delinquency rates are rising the fastest (portfolio lenders achieve foreclosure rates thirty to fifty percent lower than third-party servicers). Third-party servicers, however, are often unable or unwilling to use the same tools as portfolio lenders are currently using.[12] Recent research documents the failures of servicers to successfully modify loans.[13]

Our proposal eliminates barriers that prevent third-party servicers from effectively managing the foreclosure crisis. Commentary and evidence suggests servicers face two appreciable barriers: 1) Servicing contracts makes little economic sense in the current crisis. No one anticipated the extent of the current crisis and servicers are poorly compensated as a result. As well, servicers have too few incentives to pursue loan modification instead of foreclosure, even when modification makes good economic sense for investors. Most securitization agreements compensate servicers for costs incurred during the foreclosure process, but not for expenses associated with loan modification. Even if modification is successful, it typically does not generate sufficient fees to cover the costs of modification. Consequently, servicers often choose to foreclose, even when modification makes good economic sense for borrower and investors. 2) Servicers face explicit and implicit legal barriers to modifying mortgages

[10] According to the Mortgage Bankers Association, about 1.64 million loans started the foreclosure process as of the third quarter of 2008. Our own calculations from data obtained from Braddock Financial shows that about 900,000 securitized loans began the foreclosure process as of October, 2008.

[11] See "Securitization and Distressed Loan Renegotiation: Evidence from the Subprime Mortgage Crisis" by Tomasz Piskorski, Amit Seru, and Vikrant Vig available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1321646

[12] Of course, many other foreclosures come from FHA programs and Fannie Mae and Freddie Mac, where the government already has appreciable influence in guiding programs to reduce foreclosures.

[13] See "Rewriting Contracts, Wholesale: Data on Voluntary Mortgage Modifications from 2007 and 2008 Remittance Reports" by Alan White available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1259538 and a recent update available at http://www.hastingsgroup.com/Whiteupdate.pdf.

successfully. Some pooling and servicing agreements (PSAs) place explicit limits on loan modifications. In other cases, vague provisions in the PSAs, and the consequent threat of lawsuits, serve to limit servicers' ability to modify loans successfully.

We propose two steps to get around these barriers: 1) an Incentive Fee structure that increases payments to servicers and better aligns their incentives with investors, and 2) a Legislative Proposal that removes explicit barriers to modification in PSAs and that reduces the litigation exposure of servicers who do modify loans. Our proposal might prevent as many as one million foreclosures at a cost of no more than $10.7 billion that can be funded by TARP money. Other proposals do not address both barriers that servicers face. As well, our proposal would cost taxpayers considerably less money than other programs currently under consideration, with no requirement to provide costly loan guarantees. Losses for bad loans remain with private investors rather than taxpayers.

Incentive Fees: We believe that servicers need greater resources and stronger incentives to modify loans. We propose that servicers of privately securitized mortgages be paid a monthly Incentive Fee equal to ten percent of all mortgage payments made by borrowers, with a cap for each mortgage of $60 per month ($720 per year). The servicer would also receive a one-time payment equal to twelve times the previous month's Incentive Fee if the borrower prepays the mortgage, rewarding servicers that accept short sales. These payments would be in addition to the normal servicing fees as specified by the PSA. The program would be limited to any securitized mortgage that is below the conforming loan limit at the origination date. The Incentive Fees, which would equal about $9 billion, can be paid from money authorized under the US Treasury's TARP program. The Incentive Fees should remain in place for a period of three years, after which improvements in the economy will likely reduce the need for the incentive program.

Our Incentive Fee program would substantially encourage servicers to modify mortgages. Servicing fees would now more than cover the direct costs of modifications, estimated to be as much as $750 to $1,000.[14] Equally important, the Incentive Fee program better aligns servicers' interests with those of investors by giving them a percentage of all cash flow. By paying an Incentive Fee only when borrowers make payments, we reward successful modifications. A servicer whose loan modifications are unsuccessful and result in a quick re-default would collect few Incentive Fees.[15] Our proposal, therefore, rewards servicers for keeping future payments as high as possible without putting the homeowner in a position where he or she is likely to re-default soon after modification. This is exactly the tension that a portfolio lender deals with in its

[14] See for example Barclays 2008 Global Securitization Annual.

[15] Evidence suggests that more than one half of loan modifications in the first quarter of 2008 re-defaulted within 6 months, so it is important only to reward servicers for pursuing successful loan modifications (OCC/OTS Report, 12/2008).

own loans. Of course, there will still be circumstances when costly foreclosure will be unavoidable, but the Incentive Fee will encourage servicers to look for other options.

Legislative Proposal: We propose specific, temporary legislation to eliminate legal barriers to loan modification in PSAs for all securitized loans. We believe that Congress has the authority, under the Commerce and Spending Clauses, to modify the terms of securitization contracts.

We propose two kinds of legislated changes to PSAs. First, Congress should enact legislation that eliminates explicit limits on modification, including both outright prohibitions and provisions that constrain the range of permissible modifications. The legislation should be temporary, lasting only three years. Second, Congress should create a "litigation safe harbor" that insulates servicers from costly litigation, provided they modify loans in a reasonable, good faith belief that they are acting in the best interests of investors as a group. The safe harbor is an affirmative defense, which servicers can assert in the event of litigation. Importantly, the defense is based on evidence that the servicer held a reasonable, good faith belief in the benefit of modification, not on evidence that the modification was in fact successful or not. If investors bring suit, but a servicer successfully invokes the safe harbor, the investors will pay the servicer's actual legal costs, including attorney and expert-witness fees. Finally, our proposal therefore requires servicers to make public the details of any modification.

Our Legislative Proposal raises no meaningful constitutional concerns and has been vetted by leading constitutional scholars. The Proposal is a temporary program to moderate an avalanche of foreclosures during an economic crisis. It is more tailored and potentially less burdensome on investors than temporary legislation enacted during the Great Depression and upheld by the Supreme Court. Indeed, our program should benefit investors, because it fosters loan modification only when it increases returns—relative to foreclosure—to investors as a group.

Our Legislative Proposal addresses a number of flaws in existing PSAs, which were created when investors and underwriters did not envision a housing collapse of the magnitude we are now seeing. Although the proposed legislation will abrogate contractual rights of investors, it will also free servicers to undertake loan modifications that increase payments—relative to a foreclosure—to investors as a group. Thus, the bulk of investors will benefit from this legislation, despite the loss of contractual rights. Most PSAs do not explicitly limit modifications, but instead contain vague language that can paralyze servicers. With respect to these securitizations, our proposal can best be viewed as clarifying the interpretation of the PSAs.

Our Legislative Proposal is slightly more complicated for the minority of PSAs that contain explicit provisions barring modifications, limiting the types of available modification, or requiring that a servicer purchase any modified loans—at par value—from the securitization trust. Our proposal will abrogate provisions like these. It is important to note, however, that our legislation enables modification only when it increases overall investor value. To be sure, some junior tranche holders might be harmed. We believe that policymakers should provide compensation to these investors, who have suffered economic losses. Note, however, that compensation to junior-tranche investors will be necessary only when legislation abrogates contractual provisions that would have guaranteed, absent abrogation, cash flow rights to these investors. Our computations indicate that the total cost of this compensation would be no more than $1.7 billion.

A key feature of our proposal bears emphasis: it benefits homeowners as much as servicers and investors. A homeowner is a prime candidate for loan modification when her income is sufficient to make payments that, over time, exceed the foreclosure value of her home. Competing proposals do less for homeowners, do more harm to investors, or are more costly to taxpayers.

Second Liens and Mortgage Modifications

There is one other appreciable barrier to modifications that appears to be a major concern—the existence of second liens on properties with a delinquent or potentially delinquent first mortgage. According to our calculations from deeds records, about one-third of mortgages originated after 2000 have either a second lien or a piggyback loan (a piggyback loan is a second lien that is taken on at the same time as the first mortgage).[16] Typically, these loans provided additional credit for homeowners to purchase the house or to finance additional expenditures after the purchase.

Second liens can be a barrier to successful modifications of first mortgages. There are some cases in which modification of the first mortgage might yield greater recovery than a foreclosure to first mortgage lenders, but the servicer of the first mortgage is unwilling to pursue modification unless the second lien lender agrees to relinquish its claims. If the second lien lender does not relinquish (or reduce) its claim, a modification of the first mortgage will just allow the homeowner to allocate more of her income to the second lien.

Even if the first mortgage exceeds the home's expected foreclosure value—implying zero recovery to the second lien lenders in foreclosure—the second lien servicer has little incentive to agree to a modification that extinguishes the second lien. As long as there is some uncertainty surrounding foreclosure value, no matter how small, the servicer of the second lien would prefer foreclosure to loan modification. The former offers a slight chance of recovery to second lien lenders; the latter offers no recovery. Moreover, terms of pooling and servicing agreements might prevent the second lien servicer from agreeing to any modification that extinguishes the

[16] About 81 percent of mortgages with a second lien have only a second lien, while another 15 percent have a second and third lien, and 4 percent have 3 or more additional liens.

mortgage. As well, by delaying and appearing obstinate, the second lien lender might convince the first mortgage servicer to "buy out" the second lien at a price above its true value. This is often called a "hold-up" problem.

Professors Morrison and Piskorski and I are developing a new, voluntary proposal that would give second lien lenders financial incentives to relinquish their claims whenever a first mortgage servicer pursues modification. Under our proposal, the government would pay compensation to a second lien holder who agrees to relinquish all of its claims against the home and the borrower. This compensation would equal five percent of the current balance of the second lien, capped at $1,500 per property. If multiple liens exist, this payment would be split between the liens. This compensation could be paid using TARP funds.

In order to limit taxpayer costs, and focus primarily on foreclosure prevention, we would limit compensation to second lien lenders who relinquish their claims in response to a decision by the first mortgage servicer to conduct a significant modification of the primary mortgage. By significant, we mean a modification that reduces the borrower's monthly payments by at least 10 percent. This program would only apply to primary residences. As well, compensation would be available only when the first and second liens are held by different lenders. Finally, our proposal would apply to all second liens, because the hold-up problem applies beyond just privately securitized mortgages.

The cost of this proposal would be approximately $2.1 billion. As with our other proposal, the cost of this plan is quite moderate compared to the possible expenditure of $50 to $100 billion to reduce foreclosures. We compute the cost of compensation as follows. Using deeds records, we estimate that about 13.3 million homes are subject to both first mortgages and second liens as of Octoer 2008. Among these homes, the loan-to-value ratio exceeds 92 percent. (In our calculations, we assume a loan-to-value ratio equal to 92 percent; this allows for future house price declines of 8 percent or more.) When the loan-to-value ratio is only 92 percent, a second lien lender is unlikely to agree to relinquish its claim, for obvious reasons. We assume that around one-quarter of these mortgages are at risk of foreclosure. Among those, modification might make sense half of the time. Thus about 1.4 million second lien mortgages might require compensation for the relinquishment of their rights. If all second lien holders agree to relinquish their rights, the total cost of compensating them would be no more than $2.1 billon.

This proposal would deal with the one remaining impediment to loan modifications that impacts all mortgages. We believe that this proposal is superior to bankruptcy cramdown for many of the same reasons we do not think cramdown makes sense for first mortgages.

Stabilize the Mortgage Market and House Prices

I briefly describe a program to return mortgage markets to normal operations and stabilize house prices. Along with R. Glenn Hubbard, I have proposed that the government allow new mortgages to be issued at a rate that is 1.6 percent above the rate of the 10-year Treasury bond. With 10-year Treasury rates as low as 2.4 percent, this would immediately lower mortgage rates as low as 4 percent for conforming mortgages.

Lower mortgage rates would accomplish many things at once. Lower rates will stabilize house prices. A recent paper that I wrote with R. Glenn Hubbard suggests that house prices have already fallen at or below where fundamentals suggest, but are likely to continue to decline due to the mortgage market meltdown and the deteriorating economy.[17]

Lower mortgage rates also provide a strong fiscal stimulus, allowing as many as tens of millions of American households to refinance their mortgages, with a monthly savings of $425 that is not a temporary stimulus but permanently lower payments.[18] These lower mortgage payments could make the difference for millions of homeowners in allowing them to obtain affordable mortgages and avoid foreclosure. As well, lower rates would provide a fiscal stimulus that would total more than $174 billion per year and would almost surely induce an increase in consumption relative to a temporary tax stimulus.

Moreover, a low mortgage rate will raise housing demand significantly. We estimate that anywhere between 800,000 and 2.4 million additional owner occupants could enter the housing market in 2009.[19] These gains in new homeowners would help absorb the inventory of vacant houses, putting a floor on house price declines. TARP money might facilitate larger gains in new homeowners by helping finance low down payment mortgages through the Federal Housing Administration.

While lower mortgage rates do not require any additional government expenditure, TARP funds could provide additional help to homeowners struggling to pay off a mortgage on a house that is worth less than the mortgage. The federal government could also help facilitate many of the refinancings by offering to share some of the losses with lenders in return for taxpayers receiving a portion of the future appreciation of houses that participate in these new refinancings. These losses would be funded from the TARP. Our initial estimates were that a plan to share losses 50-50 with lenders would cost the government $121 billion. It would allow millions of additional homeowners to refinance their mortgages to an affordable level. The government would recoup some of its expenditures by retaining a stake in the future appreciation of houses refinanced under this program.

Moreover, trillions of dollars of refinancings would retire a large number of the existing mortgage-backed securities. This would reduce uncertainty about the value of existing mortgage-

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[17] See "House Prices, Interest Rates, and the Mortgage Market Meltdown" by Christopher Mayer and R. Glenn Hubbard available at http://www2.gsb.columbia.edu/faculty/cmayer/Papers/Mayer-Hubbard-BEP-10-2008-v7.pdf

[18] Calculations are available at http://www4.gsb.columbia.edu/null?&exclusive=filemgr.download&file_id=53340

[19] See calculations at www4.gsb.columbia.edu/realestate/research/mortgagemarket

backed securities. It would flood the market with additional liquidity that the private sector could deploy to other uses such as auto loans, credit cards, commercial mortgages and general business lending.

Conclusion

I believe it is essential for the Administration and Congress to address the foreclosure crisis. House prices continue to spiral downward in much of the country. Foreclosures are already taking place at an alarming rate and will only grow if we do not take immediate action.

Nonetheless, it is important to pursue sensible policies and protect taxpayers. Bankruptcy reforms that allow judges to cramdown mortgages on a primary residence will only delay the resolution of the crisis and may cost taxpayers tens or hundreds of billions of dollars.

Instead, I have put forward three plans that will provide immediate relief and appreciably benefit taxpayers, homeowners facing foreclosure, other homeowners, and banks. One plan addresses the large growth in foreclosures in securitized mortgages. That plan relies on incentive payments and legislated changes in securitization agreements to induce servicers to undertake modifications that would benefit both homeowners and investors, without relying on changes to bankruptcy laws. The plan can prevent up to a million foreclosures at a modest cost to taxpayers of $10.7 billion. The second plan deals with second liens that inhibit loan modifications and would facilitate as many as 1.4 million loan modifications at a cost of $2.1 billion. The third plan helps restore the normal functioning of the mortgage market at little cost to taxpayers. It would put a floor on house price declines and might provide a fiscal stimulus of as much as $175 billion per year. Together these programs put us on the road to recovery.

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