Testimony
Michael S. Barr
Professor of Law, University of Michigan Law School
Senior Fellow, Center for American Progress Action Fund
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Chairman Kucinich, Ranking Member Issa, and distinguished members of the committee, it is my honor to be here today to testify about the ongoing crisis in our housing and financial markets and Treasury's progress in preventing foreclosures under the Emergency Economic Stabilization Act of 2008.

There is bipartisan agreement today that stemming foreclosures and restructuring troubled mortgages would slow the downward spiral harming financial institutions and the real American economy. The federal government has a range of authorities to take action. But what has been missing is a way to get servicers, who control most of these loans on behalf of mortgage-backed securities investors, to restructure the loans themselves or sell the loans to the Treasury at a discount, so the loans can be refinanced.

To date, Treasury's efforts have largely failed. Owing a duty to countless investors with conflicting interests, servicers are paralyzed by fear of liability, restrictive tax and accounting rules, and the wrong financial incentives. What's more, contracts typically bar servicers from selling underlying mortgage loans out of loan pools. Instead, servicers are foreclosing at alarming rates, dragging down our economy with them. Subprime loan modifications have been too small scale to date to achieve the goal of keeping large numbers of homeowners in their homes.

As explained further below, we need new legislation to unlock the securitization trusts so that servicers have the authorities they need to sell loans to Treasury at a steep discount. Treasury can then restructure them, include a shared equity feature to protect taxpayers, issue new guarantees on the restructured loans, and sell them back into the market, helping homeowners and restoring liquidity and stability to our markets.

In the meanwhile, Treasury can get the ball rolling with existing authorities. In particular, Treasury can guarantee home mortgages held in trusts and in portfolios in exchange for real restructuring, and pay servicers to restructure loans. Treasury can contract with the Federal Deposit Insurance Corporation to implement a restructuring program, enlist Fannie Mae and Freddie Mac, and bolster the Federal Housing Administration, so that the Bush administration uses a "full-court press" to help troubled homeowners, stabilize financial markets, and jump start our economy.

Overview of the current crisis

The U.S. economy is caught in a vicious downward spiral of declining home prices, escalating foreclosures, rising losses on mortgage-backed securities, and disappearing liquidity. The crisis spread rapidly from the mortgage market to engulf other forms of consumer credit, commercial real estate, and municipal debt, and reached far beyond American soil. Major financial institutions failed. The risk of sustained global economic crisis remains high.

We must act aggressively to contain the crisis, reform our home mortgage system, and develop new approaches to broad-scale housing and financial-sector reform—beginning with a clear understanding of the problem itself.

Lax regulation, supervisory neglect, lack of transparency, and conflicts of interest all undermined the foundations of our financial system. Financial innovations in securitization and other factors brought increased liquidity, but also broadened the wedge between the incentives facing brokers, lenders, borrowers, rating agencies, securitizers, loan servicers, and investors. The lack of transparency and oversight, coupled with rising home prices, hid the problems for some time. When home prices and other assets imploded, credit woes cascaded through the financial system, and the lack of trust in the system meant that even sound financial institutions faced contagion from the crisis. That is why we need fundamental change in our system of financial regulation.

Alarmed by the specter of a prolonged economic slowdown, both the Federal Reserve and Congress acted aggressively to stimulate demand through monetary and fiscal levers. For too long, the U.S. Department of the Treasury simply pressed mortgage holders to restructure mortgages and suspend foreclosures on a voluntary basis. But continuing turmoil in financial markets confirmed that these actions were not enough. Restoring confidence and liquidity in credit markets required, and still requires, bold action to restructure distressed assets and contain the effects of the downward spiral in financial markets.

Rather than a measured market correction warranted solely by the underlying quality of assets, we have seen a freefall in mortgage-related financial assets and in U.S. home prices, with the crisis in credit quality extending like a contagion across the financial sector. The total inventory of homes in foreclosure reached 2.75 percent by June 2008, and delinquencies reached 6.41 percent of all mortgages. More than 2 million foreclosures are anticipated within the next two years. As of September 2008, home prices had already fallen by approximately 20 percent from their peak two years ago, and the median home price has fallen for the first time since the Great Depression. Sharply falling home prices put a growing number of homeowners underwater, with nearly 10 million households already facing home mortgage debt levels that exceed the value of their homes. Negative equity is a strong predictor of default and foreclosures.

As the crisis spread, it helped to slow the U.S. and global economies and bring down major U.S. financial institutions. The investment banking firm, Bear Stearns Cos., with significant exposure to the subprime mortgage sector, failed, and was acquired by JP Morgan Chase & Co. with the support of Treasury and the financial backing of the Federal Reserve. IndyMac Bank, a federally insured depository and major subprime lender, faced an old-fashioned bank run and was taken over by the Federal Deposit Insurance Corporation. The vaunted home mortgage giants Fannie Mae and Freddie Mac, with $5 trillion in debt and mortgage-backed securities outstanding, succumbed to the crisis and were put into conservatorship by Treasury, with promises from the department to provide up to $100 billion in capital to each institution. Soon after, Wall Street investment bank Lehman Brothers Holdings Inc. went bankrupt, and rival Merrill Lynch & Co. sold itself to Bank of America to avoid the same fate. The global insurance firm American International Group, Inc. succumbed the next day, and the Federal Reserve agreed to loan the company up to $85 billion on an emergency basis as it sought to sell off its assets—with new loans and equity investments continuing even this week to attempt to separate out AIG's bad assets from the rest of the firm.

After a run on historically "safe" money market mutual funds, which operate outside the FDIC-insured banking system, Treasury announced that it would extend the safety net by offering insurance to this entire industry for funds in place as of September 19. And the Fed and Treasury announced an array of programs designed to bolster the commercial paper market. By the end of that week, the last two remaining independent investment banks, Morgan Stanley and Goldman Sachs Group, Inc., converted to Bank Holding Companies subject to the prudential supervision of the Federal Reserve. Washington Mutual Bank went into FDIC receivership and was sold to JP Morgan, and after a rescue offer by Citi and the FDIC, Wachovia Bank merged with Wells Fargo.

In the meanwhile, Treasury, the Federal Reserve, and the FDIC's board signed off on invoking the FDIC's "systemic risk" exception under which the FDIC has now guaranteed interbank lending, senior unsecured bank debt, and uninsured depositors holding funds in non-interest bearing accounts.

The scope of federal intervention thus far has been unprecedented. Yet millions of American homeowners remain struggling to meet their home mortgage obligations.

Legislative steps to resolve the crisis

Legislation enacted in July 2008 aimed at restructuring troubled mortgages to prevent avoidable foreclosures and the resulting harm to neighboring homes and communities. Under the Housing and Economic Recovery Act of 2008, an estimated 400,000 at-risk mortgages could be restructured on affordable terms with credit enhancement from the Federal Housing Administration under the "Hope for Homeowners" program. Only loans on owner-occupied homes would be eligible for restructuring, and speculators would be excluded. Refinanced loans would take the form of new fixed-rate 30-year mortgages. Borrowers would pay insurance premiums to the FHA and would share equity appreciation in their home values. Lenders, participating on a voluntary basis, would negotiate to extinguish any second liens on the homes, agree to write down sufficient principal to meet loan-to-value and affordability guidelines, and pay a one-time insurance premium to the FHA.

This "Hope for Homeowners" program began insuring loans in the fall of 2008, but as of mid-October had only processed 42 loans. It remains to be seen whether a sufficient number of loans will be restructured to mitigate the crisis in foreclosures, and at the same time whether the federal government will be left with an adversely selected portfolio of the riskiest loans, with unknown exposure to the FHA and, potentially, taxpayers.

The legislation also included $3.9 billion for a Neighborhood Stabilization program based on a concept first published by Center for American Progress Action Fund Senior Fellow David Abromowitz. These funds are available to help hard-hit states and localities purchase abandoned and foreclosed properties and put them to reuse as affordable housing. The legislation also includes funds for homeowner counseling and new flexibility for the Federal Housing Administration's core programs. Implementation of these programs will undoubtedly take further time and attention.

Significantly, the legislation put in place a new regulator—the Federal Housing Finance Agency—for the government-sponsored enterprises (Fannie Mae, Freddie Mac, and the Federal Home Loan Bank system), along with special authority for the government to backstop these agencies in the event of their inability to raise adequate capital to maintain mortgage market liquidity. But the new Government Sponsored Enterprises' authorities did little to stem the GSE's problems, and in September 2008, Treasury and the Federal Housing Finance Agency placed Fannie Mae and Freddie Mac into conservatorship. The FHFA is now responsible for running the these entities. Treasury committed to cash infusions of up to $100 billion for each entity in the event that their liabilities exceed their assets, and Treasury is to receive stock senior in priority to all other equity, stock warrants representing 80 percent of the two companies' common stock, regular dividends, and commitment fees in exchange for Treasury's financial backing. Treasury also agreed on a temporary basis to purchase GSE mortgage-backed securities on the open market in the interest of market stability.

Finally, Treasury declared that the time had come for congressional authorization of a $700 billion program to have Treasury buy tranches of "toxic" mortgage-backed securities and collateralized debt obligations on the books of financial institutions. The administration's proposal failed to include provisions required to help homeowners restructure their troubled mortgages, and left intact the conflicts of interest and legal barriers in the secondary markets blocking restructuring.

Moreover, the administration's rationales for the program shifted significantly during the course of congressional deliberation and after enactment. The administration put on the back burner its plans to buy mortgage-backed securities, and instead has focused on using the emergency funds to inject $250 billion in capital into the banking system. The administration hoped that the capital injections would induce banks to increase their lending. However, with the economy still reeling, many potential borrowers in financial straits, troubled assets still on the books of financial institutions, and capital needs still significant given those uncertainties, the capital infusion does not yet appear to have fostered further lending expansion. Rather, capital has been deployed either to shore up the capital base in the event of further declines in asset values or to engage in merger-and-acquisition activity.

Despite the limitations of the approaches taken by the administration under the Emergency Economic Stabilization Act thus far, the act's potential is significant. Under Section 109 of the act, the Treasury secretary is authorized to "use loan guarantees and credit enhancements to facilitate loan modifications to prevent avoidable foreclosures." Under Section 101 of the act, the secretary is authorized to "make and fund commitments to purchase" troubled assets, including home mortgage loans. These authorities can be deployed now to help homeowners and stabilize our markets. In addition, the administration has at its disposal the restructuring efforts of the FDIC, the capacity of Fannie Mae and Freddie Mac over which the Federal Housing Finance Agency is serving as conservator, and the Federal Housing Administration. These tools need to be deployed as soon as possible to assist in restructuring troubled loans.

Next steps to resolve the home mortgage crisis

The administration should not wait any longer to help homeowners. There are key steps the administration should take now under existing authorities. In particular:

Guarantee home mortgages in exchange for real restructuring. Treasury can offer to guarantee troubled loans held by servicers in portfolio or trusts, if they modify troubled loans to bring debt-to-income ratios in line with prudent underwriting and sustained affordability. The guarantee on restructured loans would provide a new tool for servicers to act in the investors' best interests in modifying loans. The FDIC has proposed a plan to use the guarantee authority, and the administration should implement it.

Pay servicers to restructure loans. Servicers get paid by the trusts for the extra work of foreclosing on homes, but generally get little or nothing for successful loan modifications. Treasury could pay servicers using existing authorities to make loan modifications that meet Treasury guidelines.

Let the FDIC act now. The FDIC has led the way in seeking to end this crisis, has put forward a plan for guaranteeing troubled loans, and has the demonstrated expertise in loan restructuring when acting as receiver of failed banks. Treasury could contract with FDIC to run loan guarantee and restructuring efforts now.

Enlist Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac should be engaged systematically to refinance troubled mortgages according to standard criteria and should transparently report on their efforts on loans held in portfolio or in securitization trusts.

The announcement this Tuesday of a new streamlined modification program by the Federal Housing Finance Agency and the GSEs is an encouraging sign, but largely reflects activities that the GSEs have been engaged in for some time. Under the program, the GSEs would direct servicers to modify troubled home mortgage loans that the GSEs own or guarantee. A streamlined modification process would result in reductions of debt-to-income ratios down to 38 percent. While there are difficult technical issues yet to be specified in the program description, including whether sustainable interest rate reductions over the life of the loan will be utilized, whether the affordability matrix is sufficient, whether enough borrowers will qualify for the program given net-present-value calculations, and other essential matters, the GSE announcement is an encouraging sign for restructuring loans going forward. Now, FHFA and Congress should insist on real-time transparency regarding the GSE's modification results.

Moreover, FHFA should develop a program under which the GSEs purchase troubled home mortgage loans from other market participants, at a discount, in order to restructure them and resecuritize the loans with the GSE guarantee.

Lastly, private label securitizations, not the GSEs or bank portfolios, hold most of the troubled subprime and Alt-A mortgages, so the administration needs to redouble its efforts to find effective means to get these private label securitization trusts to engage in broad-scale restructuring of troubled loans.

Bolster FHA. The administration should dramatically increase the staffing, administrative, and technical support necessary to ensure FHA can play a strong role alongside the GSEs, Treasury, and the FDIC in restructuring troubled loans. FHA currently lacks the staffing, management structure, technological platforms, and budget to cope with the range of difficult tasks that it will necessarily need to undertake in the months and years ahead. Investing now in FHA infrastructure is critical.

New legislation to unlock securitization trusts and other key legislative and regulatory steps to encourage broad-scale restructuring of mortgages

Since January of last year, the Center for American Progress has been arguing for a modern-day Home Owners Loan Corporation, which helped American homeowners out of the Great Depression. That can work today, but to do so, we need to provide servicers with the legal authorities and incentives to sell mortgage loans to Treasury out of the securitized pools and loan portfolios, so the loans can be restructured.

Although Congress added provisions to the bailout bill to require Treasury to use its new authorities to exhort servicers toward more loan restructurings, we need to free servicers from the conflicting requirements and give them an incentive to sell mortgages to Treasury for refinancing and foreclosure avoidance. Here's how it would work:

Preserve tax benefits. Servicers managing pools of loans for investors are generally barred by contract from selling the underlying mortgage loans, but the trust agreements also provide that servicers must amend the agreements if doing so would be helpful or necessary to stay in compliance with tax rules under the Real Estate Mortgage Investment Conduit, or REMIC, statute, which provide important benefits for these securitization trusts and their investors. We propose to modify the REMIC rules to ensure that servicers have the authority and incentive to sell the mortgages to Treasury.

Legislation would provide that REMIC benefits would be denied going forward if the securitization's contract provisions have the effect of barring servicers from selling or restructuring loans under Treasury's programs. Servicers would have a legal obligation to their investors to modify the agreements to stay in compliance. Servicers could then sell loans to Treasury for restructuring. Participation in the Treasury program would remain voluntary, but the key legal impediments to participation would be removed.

Indemnify servicers. Legislation could provide a narrowly tailored indemnification for servicers who reasonably pursue loan modifications or sales under Treasury programs.

Provide legal certainty under accounting standards. Because selling home mortgage loans to Treasury would advance important public interests and not conflict with the underlying purposes of Statement 140, the Financial Accounting Standards Board should modify the statement to provide servicers with legal comfort in broadly modifying and selling mortgage loans under Treasury's mortgage restructuring programs.

Authorize judicial modifications in bankruptcy. Legislation should provide bankruptcy judges with the authority to modify home mortgages under circumstances in which the homeowner's income is insufficient to cover mortgage payments. Mortgage loans could be reduced to the current value of the property.

Pause foreclosures. While the administration is putting these systems in place, they could seek a pause in foreclosures in order to provide time for the programs to work.

Broad-scale housing and financial market reforms in the new Congress and new administration

The housing crisis we face today stems from serious systemic problems in the subprime and alternative lending markets that show our system of home mortgage regulation is seriously deficient and must be reformed. We need to fill what the late Federal Reserve Board Governor Ned Gramlich aptly termed "the giant hole in the supervisory safety net."[1] Banks and thrifts are subject to comprehensive federal regulation and supervision, but their affiliates far less so, and independent mortgage companies not at all. Moreover, many market-based systems designed to ensure sound practices in this sector—broker reputational risk, lender oversight of brokers, investor oversight of lenders, rating agency oversight of securitizations, and so on—simply did not work. Conflicts of interest, inadequate capital adequacy rules, lax regulation, and the "boom times" covered up the abuses—at least for a while. But no more.

The new administration, Congress, and the bank regulators could do much to restore integrity to mortgage markets and reduce the likelihood of such a crisis in the future. Federal regulation is necessary to combat abusive practices and restore integrity to our credit markets. We need to ensure that all participants in the mortgage process have the right incentives to engage in sound lending practices and are subject to regulatory oversight.

The House of Representatives in 2008 passed important legislation to clean up the mortgage process and regulate mortgage brokerage to drive out abuses, but the Senate has not followed suit.[2] While there are certainly improvements that could be made in the legislation, it forms a sound basis for the new administration and Congress to enact mortgage reform early in the next congressional session. Legislation should include provisions for judicially supervised modifications of home mortgages in certain narrow circumstances. In addition, the Federal Reserve's rulemakings to bar unfair and deceptive mortgage practices and to improve disclosures should be implemented immediately while the Fed works to strengthen them further. And to increase transparency, all borrowers need to be able to get firm price quotes on loans and settlement services in order to comparison shop.

Congress also should develop a new standard for truth in lending so that mortgage brokers and lenders do not have incentives to get around disclosure rules. Under this approach, an agency could determine whether a creditor's disclosure was objectively unreasonable, in that the disclosure would fail to communicate effectively the key terms and risks of the mortgage to the typical borrower. A new disclosure approach should require brokers and lenders to disclose all information favorable to the borrower so that borrowers are no longer easily steered into loans that cost more than the loans for which they would qualify. The new law also needs to increase public disclosure of broker and lender conduct and regulatory monitoring of credit standards.

To repair the broken trust and realign good incentives in our system, brokers should not be permitted to earn so-called yield spread premiums for steering borrowers into higher-cost loans. Instead, we need a system under which brokers are accountable to borrowers. Over the long run, we could shift to a system under which borrowers paid for mortgage-broker services and brokers owed a fiduciary duty to borrowers, in a similar way that financial advisers owe such duties to their investment advisory clients. In the meanwhile, enhanced disclosures and barring yield spread premiums could help to reduce abuses.

Moreover, we need to ensure that our capital market regulations—across all financial sectors—provide for transparency, appropriate capital adequacy standards, and rules regarding conflicts of interest. Congress and the new administration need to reform our secondary market regulations as well as our tax and accounting rules so that securitizations enhance liquidity and transparency even in crises, rather than serving as obstacles to crisis resolution.

There is a long history of sound lending to low- and moderate-income borrowers. Banks and thrifts expanded their prime mortgage lending, consistent with safe and sound banking practices, under the Community Reinvestment Act, or CRA. The results were impressive.[3] We should not blame the poor and learn the wrong lesson from the current crisis. Rather, we need to ensure that our mortgage finance system works for all creditworthy households.

In addition to reforming the mortgage market by taking on bad practices, we should take this opportunity fundamentally to rethink our approaches to regulation based on insights from behavioral economics. Harvard economist Sendhil Mullainathan, Princeton psychologist Eldar Shafir, and this author have argued for a new, opt-out mortgage plan.[4] While the causes of the mortgage crisis are myriad, a central problem is 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?"[5] Many borrowers took out loans that they did not understand and could not afford, with predictable results.

In retirement policy, behavioral research 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 is the mortgage they would get, unless they opted out after clear disclosures. Lenders and brokers would face increased scrutiny and the potential for liability if they provided alternative loans without reasonable disclosure. An opt-out system would mean borrowers would be more likely to get appropriate loans, without blocking beneficial financial innovation.

Congress and the new administration should begin right away the process of developing a home mortgage finance system for the 21st century, including evaluating the role of the GSEs and other participants in the system. Any such review would need to take account of the historically important role the GSEs and government agencies played in developing and sustaining a home mortgage system that, prior to the current crisis, had been the envy of the world. In particular, we need to ensure that our system continues to sustain the market for 30-year, fixed rate, self-amortizing mortgages; provides liquidity throughout all regions of the country, including during economic crises; and promotes standardization of mortgage products in the interests of home mortgage borrowers.

These proposals should also include appropriate incentives for screening, monitoring, and enforcement for consumers, investors, and other stakeholders in the system. And they should improve the alignment of the mortgage finance system with the public interest, and reduce systemic financial risk and the potential risk to taxpayers if the system fails. Developing principles based on what we need our financial system to do will help guide the process of figuring out how to get from our current crisis posture to that point.

More broadly, Congress and the new administration will also face important decisions regarding broad-scale financial reforms. The current U.S. home and global credit crises reveal significant weaknesses and glaring inconsistencies in our system of financial supervision. The government's response to the crisis raised new questions regarding moral hazard created by repeated government bailouts of a wide array of financial institutions, from deposit-taking commercial banks subject to comprehensive supervision and examination, to government-sponsored enterprises with historically weak oversight, to investment banks not generally subject to prudential supervision.

The federal government now has served as a lender of last resort to a broad array of institutions that, prior to the interventions, had no explicit authority to borrow and no comprehensive prudential supervision or serious capital requirements to contain the consequences of failure, or to protect the financial system and taxpayers. Ad hoc intervention, even if necessary, is no substitute for a system of financial regulation. Now there is no way to put the genie back in the bottle. Congress and the new administration should enact regulatory rationalization, prudential supervision, transparency, and capital requirements across the financial sector.

Conclusion

The new administration and Congress should undertake a series of initiatives to restore integrity and stability to our financial markets. Innovation is a hallmark of America's financial system, and with needed changes in governmental policies and regulatory supervision, we can expect our financial system once again to be vibrant and strong.

Endnotes

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[1] Edward M. Gramlich, "Booms and Busts: The Case of Subprime Mortgages," Paper presented at the Federal Reserve Bank of Kansas City symposium, "Housing, Housing Finance, and Monetary Policy," in Jackson Hole, WY, August 31, 2007, available online at http://www.kc.frb.org/PUBLICAT/ECONREV/PDF/4q07Gramlich.pdf.
[2],*The Mortgage Reform and Anti-Predatory Lending Act of 2007*, HR 3915, 110th Cong., 1st sess.
[3] Michael S. Barr, "Credit Where it Counts," New York University Law Review 80 (2) (2005): 513-652.
[4] Michael S. Barr, Sendhil Mullainathan, and Eldar Shafir, "Behaviorally Informed Home Mortgage Regulation," Working Paper (Joint Center on Housing Studies, November 2007).
[5] Gramlich, "Booms and Busts."