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Inside Mortgage Finance Publications, Inc.

Hearing of the Congressional Oversight Panel

October 27, 2010

Members of the Congressional Oversight Panel, thank you for the opportunity to discuss the current state of the housing market and its effect on the stability of the financial system.

My name is Guy Cecala and I am the CEO *of Inside Mortgage Finance*, a specialized information firm that publishes a variety of products related to the residential mortgage market and its key players. For the past 26 years, my company has tracked the many changes seen in the U.S. mortgage market – the boom and bust in nonprime lending as well as the growth in mortgage securitization. Many of the statistics presented in this testimony comes from the various databases compiled by *Inside Mortgage Finance*.

My testimony today will focus on a number of specific issues that the Panel has asked me to address. Any opinions expressed are my personal opinions and do not represent the views of *Inside Mortgage Finance* or any of its publications.

Current state of the residential mortgage market and trends and economic fundamentals that are driving the market

On the surface the U.S. mortgage market currently is functioning quite well. Long-term interest rates are very low and there is no shortage of mortgage capital available for borrowers with strong credit looking to buy a home or refinance an existing mortgage. But looking deeper we find a mortgage market that is overwhelmingly dependent on government support. About 90 percent of all new mortgages made this year have carried some sort of a government guarantee, according to numbers compiled by *Inside Mortgage Finance* (see Exhibit 1). Currently, the lion's share of new mortgage activity is dependent on the mortgage programs of Fannie Mae, Freddie Mac or FHA. What little private sector mortgage activity there is involves mostly home equity and high balance jumbo mortgage lending, two areas where there is no government financing available.

To put the current mortgage market landscape in perspective, it is important to note that as recently as four years ago the government accounted for only 30 percent of the mortgages made in this country. How did we get here?

A combination of a dramatic rise in nonprime and nontraditional lending and an increased dependence on mortgage securitization created a mortgage market that was extremely dependent on funding from worldwide investors who had little appetite for risk or losses. When the U.S. housing market began to unravel and the risks of nonprime mortgages were exposed, these investors quickly abandoned the non-agency mortgage

securities market and limited their investments to only those mortgage securities that carried a government guarantee.

The current lack of investors for non-agency mortgage securities has limited private-sector mortgage funding to those firms willing and able to hold loans in their own portfolios. Additionally, for competitive and pricing reasons, private-sector lending generally is limited to those mortgages where there is no government funding available.

The impact of HAMP and proprietary loan modifications performed by mortgage servicers on the recovery of the housing market

Between 2005 and 2007, *Inside Mortgage Finance* estimates that $8.5 trillion in new residential mortgages were made in this country. About one-third of that total – or roughly 13 million loans – could broadly be categorized as nonprime mortgages with a high risk of default (see Exhibit 1). The bulk of these loans were made to subprime borrowers, had little or no documentation, involved low or no downpayment, or had some other high risk characteristic. It is this large group of loans that has produced the most defaults and foreclosures to date, although a growing number of problem mortgages can be attributable to prime mortgages involving borrowers who have lost their jobs or seen a significant reduction in their income. Currently, there are about 4.5 million mortgages that are seriously delinquent (more than three months) or already in foreclosure. This has been the primary target group for loan modification efforts.

Since the mortgage industry moved to step up its proprietary loan modification efforts in 2008 and then in mid 2009 shifted its focus to implementing the administration's Home Affordable Modification Program, the number of problem mortgages and borrowers facing foreclosure has risen. While a case can be made that these loan modification efforts may have limited the growth in foreclosures over the past several years, it is hard to claim they have actually reduced either the inventory of seriously delinquent mortgages or the number of new foreclosures, as both have grown.

The large number of problem loans and record level of foreclosures over the past two years have created a housing market where nearly half of all home purchase transactions involve distressed properties – specifically real estate owned (properties acquired by a lender/investor through foreclosure) or short sales (properties sold by a borrower with a mortgage in default for less than the mortgaged amount to avoid foreclosure). According to the *Campbell/Inside Mortgage Finance Monthly Survey of Real Estate Market Conditions*, 47.7 percent of home purchase transactions nationwide in September 2010 involved distressed properties. This was up from an already high 44.8 percent level seen a year earlier (see Exhibit 2).

It is hard to talk about any recovery of the housing market when the share of distressed property transactions remains close to 50 percent. And despite both private and government efforts to modify seriously delinquent mortgages and reduce foreclosures, there has been no meaningful decline in the inventory of distressed properties found in the housing market.

Have these modifications efforts had a significant impact on the housing market?

According to the Department of Housing and Urban Development and the Treasury Department, the total number of successful mortgage modifications that have been made since April of 2009 is about 2.2 million (495,900 HAMP plus 1.68 million proprietary reported by HOPE Now). During the period, the number of problem mortgages and foreclosures outstanding has grown from about 4 million to 4.5 million. From a strictly mortgage market perspective, modification efforts have done little to curb the growth in problem loans and foreclosures. Additionally, the increase in the number of super-delinquent mortgage borrowers (those who have not made a payment for a year or more) has raised the specter that delays in reviewing and approving or rejecting modification requests may have the unintended consequence of increasing the number and severity of unresolved problem mortgages.

The expected re-default rate on modified mortgages (estimates range from 30 to 50 percent) also could create more foreclosures and distressed property sales going forward, although it is too early to tell how modified mortgages will perform in the current high unemployment economic environment. Even a re-default rate at the lower end of estimates would put more than 600,000 additional distressed properties into the housing market at time when it is struggling to unload an already high inventory.

At best, mortgage modifications appear to be deferring – as opposed to permanently resolving – the foreclosure crisis as most modifications offer payment relief for a limited period (generally five years). After that period, most borrowers will face not only a return to higher monthly payments but also possibly a large bill for any previously missed or deferred payments.

Why has the number of proprietary servicer modifications outpaced HAMP modifications?

According to the HUD/Treasury numbers, proprietary servicer modifications have outpaced HAMP modifications by about 3-to-1 since the HAMP program was launched in April of 2009. Significantly, the gap between HAMP and proprietary modifications appears to have increased over the past several months.

There are a number of reasons for this large discrepancy. The main one is the simple fact that proprietary modification programs are much more flexible and easier to administer than HAMP, which has tough government mandated underwriting and documentation requirements. In general, a mortgage servicer can qualify just about any mortgage borrower in default for a loan modification if they decide it is in the best interest of the investor or investors holding the mortgage. This is not the case with HAMP where there are very specific qualifications and documentation requirements that must be met before a modification can be approved.

But another reason for the discrepancy is that proprietary mortgage modifications tend to be less aggressive in terms of payment reductions than HAMP modifications. Historically, proprietary load modifications have involved a restructuring of a defaulted mortgage. These proprietary efforts primarily were aimed at bringing a borrower current on their mortgage payments but not necessarily lowering a borrower's monthly payments.

In contrast, HAMP was established with the primary goal of aggressively reducing a defaulted mortgage borrower's payments to a low affordable level – specifically 31 percent of their income.

While there is relatively little in the way of specific information on changes to borrowers' mortgage payments with proprietary modifications, HOPE Now reported that 78 percent of completed proprietary modifications during the first half of 2010 resulted in some reduced principal and interest payments. This contrasts with HAMP where all successful modifications result in a fairly large reduction in most borrowers' monthly payments. Most proprietary modifications don't offer borrower payment reductions as deep as those mandated by HAMP.

The size and type of mortgage modifications used with troubled loans has been shown to have a big impact on re-default rates. Modified mortgages with little or no payment reductions historically have experienced large re-default rates, 50 percent or higher, within one year of modification. Meanwhile, modified loans with big payment reductions – such as those found with HAMP – have posted re-default rates as low as 25-30 percent.

Nevertheless, it is often hard to compare re-default rates by modification type since economic conditions, which have a major impact on re-defaults, can change significantly during any period of active modifications. For example, unemployment has emerged as a leading cause of re-defaults in recent months and that impacts modifications regardless of the size of mortgage payment reductions.

Review of recent foreclosure paperwork controversy and its impact on the housing market and the overall state of the financial markets

The basic infrastructure of the mortgage servicing industry was created to collect and pass on mortgage payments from borrowers who regularly – if not automatically – pay their bills on time. It is a highly automated process designed for good economic times and with little personal contact in mind. Five years ago, less than 2 percent of all mortgages being serviced – or about 1 million loans – were seriously delinquent or in foreclosure, according to the Mortgage Bankers Association's *National Delinquency Survey*.

Fast forward to 2010 when the volume of problem mortgages has jumped to roughly 4.5 million. While most mortgage servicers have beefed up their staff to deal with the more than four-fold increase in problem mortgages, the industry and its contractors are still overwhelmed with the servicing demands created by record-high mortgage defaults, requests for loan modifications and foreclosures. Meanwhile, basic mortgage servicing fees have remained largely unchanged providing little financial incentive for servicers to substantially increase their overhead costs by hiring more staff.

Given this environment it is not surprising to learn that paperwork or processing shortcuts may have been taken by some servicing-related personnel and contractors, particularly in the paperwork-intensive area of foreclosure filings. Three of the top five mortgage servicers in the country – Bank of America, JPMorgan Chase, and GMAC/Ally Bank – have acknowledged some sort of procedural problems or errors with foreclosures in the

23 states in the country that require court review and approval of foreclosures. These three firms service more than one out of every three mortgages outstanding in the U.S.

But despite temporary freezes on foreclosure evictions and foreclosure sales, all three servicers have indicated their foreclosure paperwork problems are manageable and they reportedly are taking steps to correct and resubmit foreclosure affidavits where necessary. The emerging view in the mortgage industry is that foreclosure problems are largely procedural and can be corrected fairly quickly.

Meanwhile, many if not most state and federal financial institution regulators have announced plans to review mortgage foreclosure practices by servicers. Significantly, all 50 states have signed on to investigate whether any violations of state laws have taken place and whether legal action may be required to protect the rights of consumers and homeowners.

Whether or not the housing market or the larger financial markets feel any major impact from the current foreclosure paperwork controversy depends on whether mortgage servicers can easily correct any deficiencies uncovered with foreclosure filings. The risk is that some of the investigations now underway uncover criminal misconduct or large-scale errors that force foreclosures to be put on hold for an extended period of time.

Any significant delay in foreclosures – three months or more – increases the backlog of distressed properties the housing market must ultimately resolve. Meanwhile, any criminal violations that are uncovered could subject major banks to litigation-related costs – both from investors concerned about delays in foreclosures and from potential damages that courts could award.

Although most mortgage servicers utilize similar resources and procedures for pursuing foreclosures, it is difficult to ascertain how widespread foreclosure processing irregularities may be in the mortgage servicing industry. While some major servicers have readily acknowledged foreclosure errors, others have denied uncovering problems with their procedures and practices.

Title transfer issues and the mortgage securitization process

The recent controversy surrounding foreclosure paperwork and processing has also resurrected legal questions about whether the securitization process of the past decade or more legally transfers ownership of individual properties and legally allows servicers to pursue foreclosures on the behalf of mortgage security investors.

It is hard to imagine that any legal challenge of the title transfer process commonly used with securities will prevail given that this system was originally vetted by a small army of attorneys from the rating services, the two government-sponsored enterprises and even regulators. It has been used in thousands of foreclosure cases in all states for many years. Nevertheless, mortgage servicers generally have the option of foregoing the use of automated title transfers and resorting to more manual title recordings. But it's a process that will further delay foreclosure actions.

Exhibit 1

Government Share of Mortgage Originations

(Dollars in Billions)

Year/ Quarter	VA	FHA	Fannie/Freddie	Total Originations	Agency Volume	Agency Mkt Share
2000	$22.21	$93.12	$375.83	$1,048.00	$491.15	46.9%
2001	$35.43	$131.24	$914.93	$2,215.00	$1,081.60	48.8%
2002	$41.95	$145.05	$1,270.36	$2,885.00	$1,457.35	50.5%
2003	$66.15	$165.33	$1,912.40	$3,945.00	$2,143.89	54.3%
2004	$35.31	$93.66	$892.29	$2,920.00	$1,021.27	35.0%
2005	$24.89	$57.53	$879.13	$3,120.00	$961.54	30.8%
2006	$24.51	$53.73	$816.88	$2,980.00	$895.11	30.0%
2007	$25.16	$79.54	$1,062.02	$2,430.00	$1,166.72	48.0%
2008	$40.58	$253.87	$899.82	$1,500.00	$1,194.28	79.6%
2009	$74.03	$375.79	$1,178.67	$1,815.00	$1,628.49	89.7%
2010-6mos	$29.67	$149.03	$411.18	$660.00	$589.88	89.4%

Source: Inside Mortgage Finance

Share of Nonprime Originations by Year

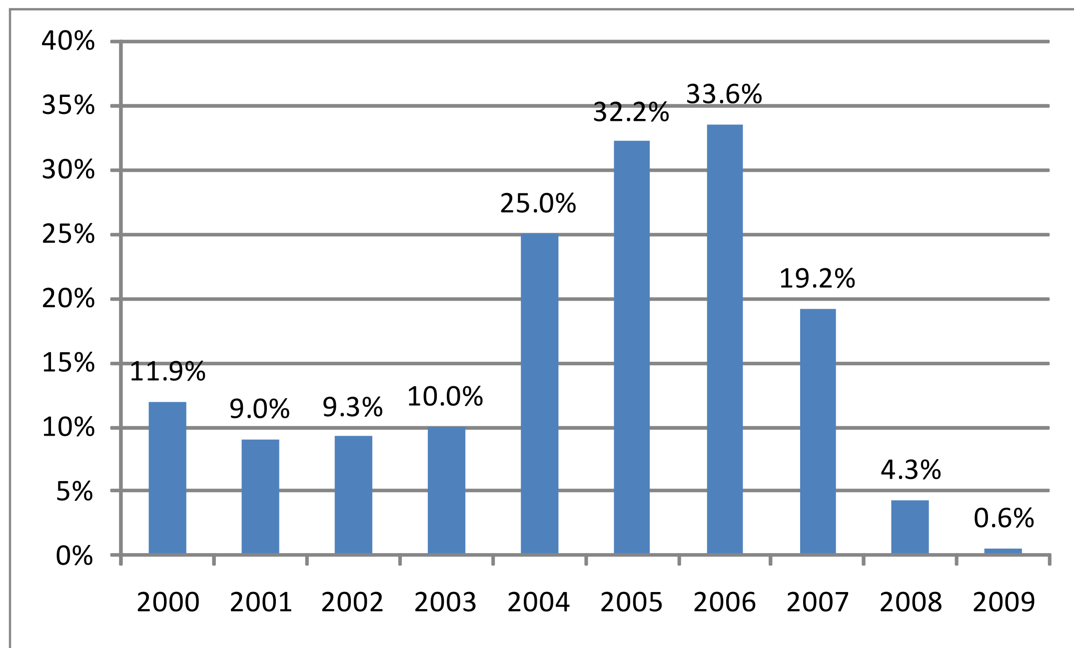
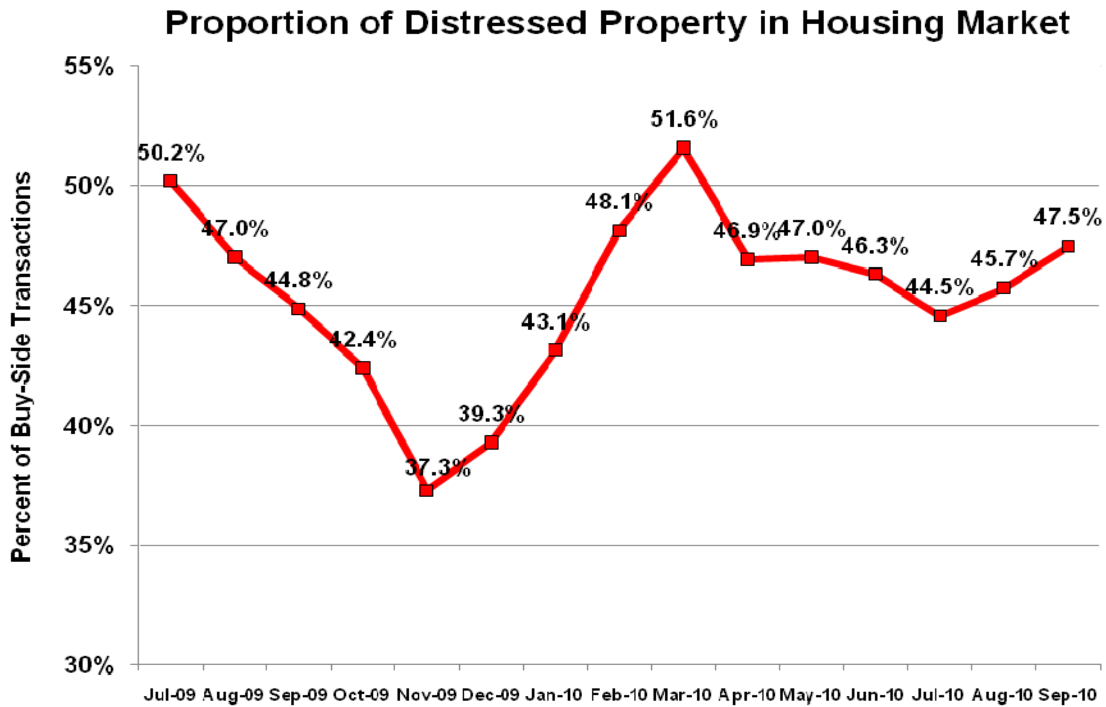
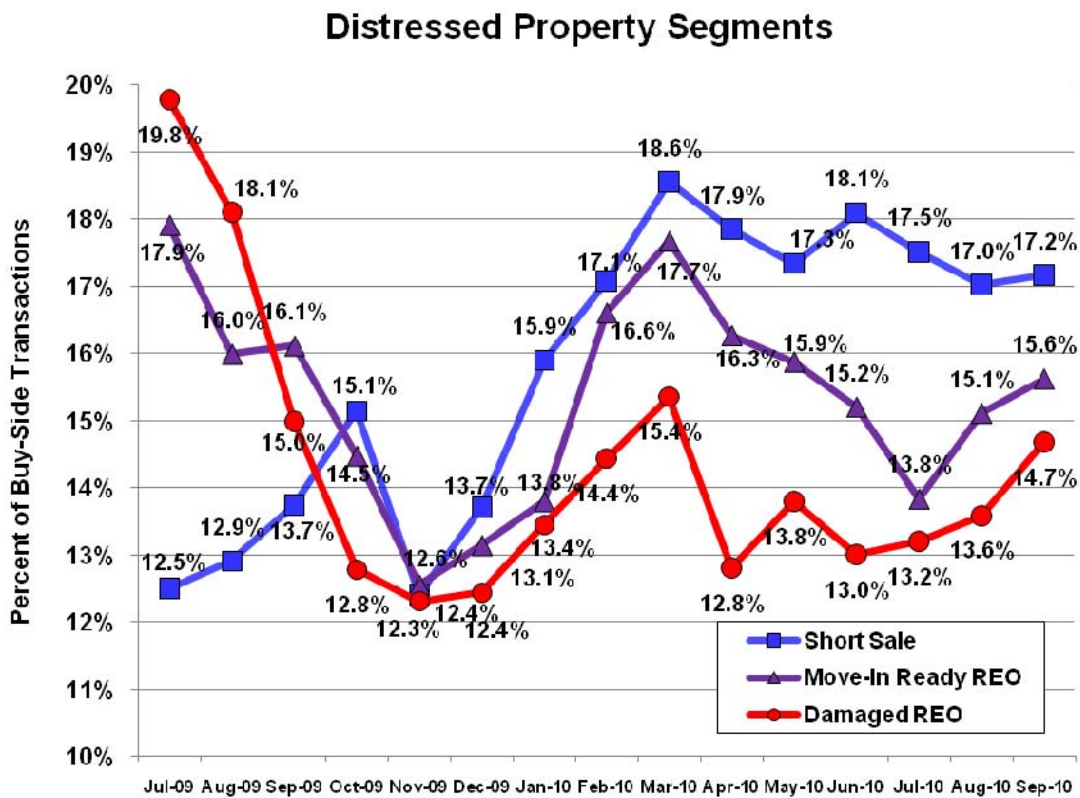


Exhibit 2





Source: Campbell/Inside Mortgage Finance Monthly Survey of Real Estate Market Conditions