“The Foreclosure Crisis and What is to be Done” DRAFT

Testimony prepared for

HEARING TITLED

“CURRENT TRENDS IN FORECLOSURE AND WHAT MORE CAN BE DONE TO PREVENT THEM”

ON

JULY 28TH 2009,

BEFORE

THE JOINT ECONOMIC COMMITTEE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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Chairwoman Maloney, Vice Chairman Schumer, and other distinguished members of the Committee:

Thank you for the invitation to testify at today’s hearing on “Current Trends in Foreclosure and What More Can Be Done to Prevent Them.” It is my honor to be here today to discuss the continuing wave of foreclosures for nonprime borrowers in the residential housing market and current policy options to reduce foreclosure rates and modify mortgages.

Today according to the MBA, the foreclosure rate is 400%, four times the historical average and the highest it has ever been since the Great Depression.

It is fair to say that the considerable response to date by the federal government has not yet worked to stem this crisis. Why is this? While much has been done and more can be done, there is a fundamental problem that is difficult to address through policy initiatives. In my comments today, I will discuss this, the causes behind the difficult situation we are in today, and what might be done going forward.

The problem of foreclosed homes and mortgages in default started in a wave of foreclosures of subprime loans; in the coming year there will be another wave of foreclosures, due to the so-called recasting of payment option mortgages. These and other complex nontraditional mortgages were a very small part of the mortgage market until they grew at an alarming rate starting in 2003; by 2006, they were almost half of the total volume of mortgage originations. As these untested, seemingly affordable, but unsustainable mortgages, were originated, they fueled an artificial house price boom which inevitably collapsed. While the initial source of the problem was recklessly underwritten nontraditional mortgages, the asset bubble this created, the artificially and unsustainably inflated house prices, has been and is now a problem for all who borrowed for homes in the years 2003 and beyond. Homeowners who borrowed conservatively, putting 20% down are now in trouble, even though they borrowed using tried and tested mortgages with steady mortgage payments; if they must sell due to job loss for example, they will be forced into foreclosure.

Americans are now increasingly threatened with loss of their homes and their jobs and the problem will get worse before it gets better.

The chart that is attached, the growth in foreclosures and the decline in house prices; this demonstrates the role of plummeting house prices in the worsening foreclosure problem. As average home prices fall, for more and more households, the amount for which they could sell their homes is less than what they owe on their mortgages. A loss of a job, illness, sudden sharp increases in required mortgage payments will force owners to sell and will force foreclosure, since homes cannot be sold for the amount of the mortgage due. Today the threat of job loss is worsening as unemployment grows and the new wave of sharp rises in mortgage payments required for option ARMs this coming year will hit homeowners and home prices will continue to fall.

Are there steps we can take now to mitigate the crisis? The crisis will abate when home prices stop falling. This is because the level of prices determines whether it is possible to repay the mortgage upon sale. When will that be? Home prices are still falling although the rate of decline is decelerating. They will continue to fall until the fundamentals turn around. A key factor in the continuing problem before us is growing unemployment, which must be controlled, thus the importance of fiscal stimulus that is currently in place. It is also critical that mortgage rates remain affordable, thus the value of continuing federal support for FHA and the GSEs as well as maintaining the historically low mortgage and interest rates. Nonetheless it is important to stem excess foreclosures which are adding to the forces driving home prices down. In an adverse feedback loop, more homes on the market pull down prices, which results in even more homes that cannot sell for the mortgage amount. This feeds an expectation that prices will fall more, further foreclosures, and a downward spiral.

Losses upon foreclosure are extreme. However, if mortgage amounts due exceed home values, loan modifications based on lowering or postponing interest rate payments may not be able to stem this growing underlying problem. This is in part due to the lack of incentives and capacity of mortgage servicers to respond to the problem. The recently issued GAO report has a number of suggestions and in fact the administration is convening a meeting today to encourage further efforts. In addition, it would be useful, as suggested in the Penn IUR Task Force Report to HUD, to monitor the progress of the HAMP program spatially, since as documented by research (see Wachter 2009 and Wachter, forthcoming, and Bernstein et al.) there is an important spatial component to the problem. Loan modifications with principal write-downs are also necessary. This involves marking mortgages, held by banks, to market. There is an uncomfortably high probability that the Obama modifications will not succeed in quelling the foreclosure crisis due to the impact of so many underwater homeowners being so deeply underwater.

The financial system that triggered the crisis encouraged the production and securitization of uneconomic loans which eventually brought the system down. Is a less pro-cyclical financial system an achievable goal? I have written with co-authors and wish to enter into the record an article to appear in the Yale Journal on Regulation which addresses the underlying failure of the regulatory and market structure. There we address the incentives to dismantle lending standards and the artificial housing boom which made it seem that the loans being made were indeed safe when they were lethal. Going forward regulatory supervision needs to be put into place to prevent this.

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