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USING FHA FOR HOUSING STABILIZATION AND HOMEOWNERSHIP RETENTION, PART I

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

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USING FHA FOR HOUSING STABILIZATION AND HOMEOWNERSHIP RETENTION, PART I

Wednesday, April 9, 2008

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Kanjorski, Waters, Maloney, Velazquez, Watt, Sherman, Moore of Kansas, Capuano, Clay, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Bean, Moore of Wisconsin, Ellison, Klein, Mahoney, Wilson, Perlmutter, Murphy, Donnelly, Foster; Bachus, Castle, Royce, Lucas, Manzullo, Biggert, Miller of California, Capito, Hensarling, Garrett, Barrett, Neugebauer, Price, McHenry, Campbell, Putnam, Bachmann, Marchant, and Heller.

The CHAIRMAN. The hearing will come to order. I said, the hearing will come to order; that means people will please be quiet and shut the doors. People can come in or out, but the door has to be shut. Members of the staff, please go and shut that door. There is an overflow room. There isn't an overflow room? I apologize for the misinformation. We do share our room with the Appropriations Subcommittee, and that apparently preempted it.

First, procedurally, under the rules of the—excuse me. Do not stand in the doorway. The door is either to be open or closed. Are there any empty seats? I would urge people to take empty seats. If they are set aside for someone who is not here, feel free to take them. There are some seats over there; there is a seat in the front row; and all seats are available. I apologize for the overflow room. We will have to make some arrangements in the future.

First, procedurally, under the rules of this committee, opening statements are 10 minutes on each side, with each side having the ability to ask questions for an additional 10 minutes. Regrettably, that is the case today, so we are going to have 20 minutes of opening statements on each side. I apologize to the witnesses. It is an important subject. I would urge members to be as brief as possible, but we will proceed now with opening statements, and I will begin with mine.

First of all, I do want to say that those who don't believe in coincidence have been undercut today by the remarkable coincidence of the announcement by the Bush Administration of substantial changes in the FHA Secure Program on the day before our hearing. We had heretofore heard from them that they were pretty satisfied

with it, that it was doing wonderful work. In February, the then-Secretary said it helped 100,000 people. We had heard some in the Administration say that they did not think that we should do anything to increase taxpayer risk.

Now the proposal we are considering today would urge those who hold the loans to reduce the principal amount, a suggestion made first by the Chairman of the Federal Reserve, Mr. Bernanke, and we then said that if the principal amount was reduced sufficiently by the securitizers with no order from us, since we are not eligible or able to do that, that we would broaden the eligibility of the FHA and let these people come to the FHA with the mortgages to be financed. Some said, correctly, that is putting taxpayers at risk, and some pointed out that there are people who borrowed more money than it turns out they can now repay, who would be the beneficiaries of this. That is, they would be the beneficiaries of their mortgages being written down in principal by the holder, and they would then be able to come to the FHA under more liberal terms than previously. And I am pleased to see that the Bush Administration now agrees with that approach.

We have some differences, obviously, in degree, but there does now appear to be agreement that it would be a good thing for the servicers to write down the principal. And the reason for that is, the original Administration approach was simply to hold off increases in the interest rate so that people could refinance.

But we discovered that people who now have house equity less than the mortgage could not be financed, so that some approach has to be made to the principal. We have a substantial amount of agreement now, and those who think that we should do nothing that could theoretically or even actually expose taxpayers to more risk will have to deal with me and the Bush Administration together and we will work this out.

There are still some differences, and we will address them. There is the notion of an auction mechanism, and that is something which evolved out of discussions we had with the Federal Reserve System. I know Governor Kroszner talks about that, and we will talk about that some more in the conversation. There is a question of the speed.

But now I have one other issue I want to address. The linchpin of what we are doing, of what Secretary Paulson began doing, of what HUD Secure does, all of it begins with a decision by the people who hold the mortgages to write them down in some way, to defer. We recognize the sanctity of a contract. We have passed legislation in this House that will make it less likely that some of these mortgages will go forward in the future, but we are not empowered, nor should we be, to abrogate existing contracts, and we are not trying to do that. This begins with voluntary action on the part of the holders.

We believe that what many of them will discover is that going to foreclosure would leave them worse off than if they were to make these arrangements. And so we encourage them to do that, and both the approach we take, and the approach the Administration is now taking offer them incentives to do that. It basically deals in part with the economist problem of the commons. That is, there are things which you might not want to do if you were the

only one doing them, which you might be more willing to do if you knew that a lot of other people were doing them because there could be a cumulative beneficial effect. So we have agreed on that, but it still requires voluntary action.

We have recently heard from some of those who are in the business of servicing mortgages that there is a reluctance to go along. One of the neighborhood advocacy groups most involved in this said, well, they have run into problems because they find that it's not the investors who are so resistant as it is some of the servicers. Our colleague from Delaware, not yet with us, Mr. Castle, proposed a bill to try and immunize the servicers from lawsuits if they in fact did what was economically responsible. But the securitizers say, well, they don't want that. They think it might be—as I read in yesterday's Congress Daily—pressure on them.

I am troubled, and there have been people who argue that from the securitizer's standpoint, some of them have transaction fees that might be lost if these things were resolved. We cannot compel the securitizers—the servicers. I keep saying securitizers, but I mean servicers. We cannot compel the servicers to take certain actions, because they have rights. On the other hand, this committee and the House and the Congress are considering legislation going forward. We in fact put some obligations in the bill that passed this House which were somewhat controversial, but the bill passed the House by well over two-thirds, to put some obligations on those who did the securitizing.

We will be acting next year, and as is now clear—Secretary Paulson and others have said so—we are going to have to do a substantial redo of financial institution regulation. I want to put the servicers on notice. We can't make them cooperate. But if we see a widespread refusal on the part of servicers to cooperate voluntarily in what we think is an important economy problem, and in which are trying to accommodate their interests and not be coercive, they can expect much tougher regulation in the future. Tough regulation is no one's first choice, and it should not be anyone's first choice. But if we do not get the degree of voluntary cooperation we want—and we are asking. We are trying to give incentives. We are trying to make this—the gentleman from Delaware who has now joined us has a bill that would help them to not be sued. We are trying to give them some economic incentive to help us stabilize the whole economy. But if the anecdotal evidence I have heard, that the servicers are resistant to cooperating, turns out to be the case, and if we were to get this approach adopted—and there are differences, but some commonality between ourselves and the Administration—and we don't get much of a voluntary buy-in to this, then I have to say that the response will have to be probably more regulation than people might like to see.

So I do want to put that element on notice, that they have the ability to influence what this Congress will do going forward. Because like I say, we will work as hard as we can to respect their contract rights to create conditions in which it will be in their interest to cooperate. And if that doesn't work, then we can't abrogate contracts, but going forward, we can be much more restrictive.

The gentleman from Alabama.

Mr. BACHUS. I thank the chairman for holding today's hearing on proposals to stabilize the housing market, prevent avoidable foreclosures, and therefore stabilize the economy.

It is important for the committee to continue to focus its attention on the housing market and its effect on borrowers, financial institutions, the economy, and communities at large. And we have, I think, if anything else in this past year, come to appreciate the interconnectivity of our different industries; a problem in one area becomes a problem in all areas.

We have a situation today, and whether you call it a short-term liquidity and credit crisis or whether you say we are in the throes of a recession, it is a serious problem, and we have alternatives. Any time you are confronted with a crisis, one alternative economically is the laissez-faire approach. You can let the market sort it out. Capitulation can be a very painful thing—sometimes refer to that as a washout—can be very costly. We have already apparently chosen not to do that in the intervention in Bear Stearns where counterparties at least have been—in a sense, their losses have been mitigated or prevented on at least a short-term basis. So we have intervened on Wall Street, maybe not on Main Street, but we have intervened. We have stepped in between what could be a very painful self-regulation by the markets, which can be very efficient and very quick.

And another approach is—another approach and the approach we have done, is to intervene after the fact, after we have a problem, after the problem has already happened. And we—that's what we're faced with. We all agree the problem is here. So you can intervene after the fact, or you can just let the market sort it out.

There is a third approach, and the chairman mentioned this approach. I'm not—we don't have this approach in this situation, but we ought to remind ourselves that there's always a more reasonable approach than letting the market sort it out or government intervention, which carries with it terms like "bailout" and "taxpayer expense." And that third alternative is a regulatory environment approach where you have reasonable regulations, where the government sets standards of transparency and operations within well-defined boundaries.

For example, in the subprime market, to prevent the fraud, misconduct, and misrepresentation which was rampant in the subprime lending market, Chairman Frank and I together began to collectively warn that this was happening. The industry said they were regulating themselves. They were doing a good job of it. We found that—and that's always a wonderful approach, if it works. If the industry will regulate itself, that's great, but they didn't do that.

We passed a licensing and registration for brokers, for all mortgage originators. That's still over in the Senate. That hasn't happened. The problems we had with renegade brokers and mortgage originators within the banks still exist. We have done nothing to prevent future crises in that regard. As we talk about this, I hope all the regulators—and these problems, I have been here 17 years, and we have problems that we have all agreed on when I came here that still have not been collectively addressed. And one, I think, is one that right now has been some period of time, is past

due, is getting together and coming up with some comprehensive solution that sees we don't—we're not up here again with a whole new round of these things, once the market gets liquidity again.

Warren Buffet said that it is only when the tide goes out that you learn who has been swimming naked. The tide on home price appreciation has ebbed, and unfortunately, we are now seeing that everyone is exposed. The ingredients of the current turmoil in our economy were individual loans of borrowers and lenders who did not appreciate the risk. Mortgage-backed securities that investors and financial institutions overvalued, and complex structured financial instruments that regulators, credit reporting agencies, and investors did not understand.

The consequences of these market and regulatory failures continue to resonate through the global economy. The focus of today's hearing is Chairman Frank's proposal to encourage lenders and investors to write down the principal on certain mortgages to a percentage of current market value and refinance those loans with an FHA guarantee, with the goal of permitting borrowers to remain in their homes, thus stabilizing house prices. He should be commended for developing a proposal that addresses a complex problem in a creative and ambitious way.

Nonetheless, any plan that would require American taxpayers to assume the risk incurred by mortgage lenders, investors, and other borrowers during the runup in housing prices earlier this decade raises serious questions. The fundamental question and issue is fairness. Out of 55 million mortgages currently outstanding, 51 million are being paid on time. Now the challenge is, there are 4 million that aren't. Some of those are just lenders who borrowed money, and knew they shouldn't have borrowed it, speculators. There are others who were truly the victim of fraud and misrepresentation.

But does the chairman's plan unfairly confer a benefit on these borrowers, some of them trying to do the right thing, others being very reckless, at the expense of all taxpayers? As I understand it, the proposal rewards some homeowners who assumed housing prices would continue to rise by permitting them to avoid the consequences of their wrong assumption. For these homeowners, the chairman's plan seems to me to be a heads I win, tails you lose, proposition. The losers are the homeowners and renters, investors and speculators who behaved irresponsibly, or who were the victims in certain cases of fraud, and those are the real hard cases.

The losers, however, are going to be the homeowners and renters who behaved responsibly, yet will now be required or could be required to pony up their hard-earned dollars in a time of rising gas prices and other stresses to bail out those who did not act responsibly or were the victims of fraud. And if housing prices continue to decline and borrowers prove incapable of making the payments on their FHA-insured mortgages, under this plan, the taxpayers would pay.

Mr. Chairman, this sends a dangerous message. When financial institutions and individuals take on excessive and ill-advised risk, the government will always ride to the rescue, or so they will assume. Sending this message now will only incentivize such behav-

ior in the future, encouraging future severe market disruptions like the one we're living through today.

None of us who owns a home enjoys watching the value of that asset decline. But the simple fact of the matter is that housing prices rose at an unsustainable rate over the past few years, far outstripping gains in personal income and the long-term trend in housing price appreciation. Until the markets stabilize, prices will need to return to the levels ordinary Americans can afford. That is a beneficial effect of what we're seeing now. This process of market correction, while undeniably painful, is a necessary and unavoidable reality.

Government intervention to impede the return to the long-term trend line, no matter how well-intentioned, is likely to do more harm than good. I think kicking the can down the road for even a more severe day of reckoning, particularly with our—the deficits in government spending for the government to assume more liability is particularly risky.

Finally, in addition to asking whether proposals like the chairman's represent good public policy, we must also ask ourself whether they can be implemented in practice. Critics have pointed out the enormous cost and time it would require to re-underwrite millions of new mortgages. And there remains the problem of existing second liens on existing mortgages while the chairman's discussion draft addresses—or does not address these issues, or not adequately.

Thank you again, Mr. Chairman, for holding this hearing. I thank all of our witnesses for joining us this morning. We look forward to your testimony.

The CHAIRMAN. The gentlewoman from California, chairman of the Housing Subcommittee.

Ms. WATERS. Thank you very much, Mr. Chairman. I'm very pleased about these hearings that you are holding. I think that we're almost a day late and a dollar short on helping the citizens of this country who have been foreclosed on and others who are facing foreclosure. And I think the proposals that you are bringing forth, that I am bringing forth, are good proposals that will finally give real assistance to the citizens who have been wondering what are we waiting for here in Washington, D.C.

I understand that the President, this Administration, is announcing some proposal as of yesterday. I don't know what it is, but let me just say that we have all been fiddling while Rome has been burning. And I want to thank you for convening this hearing on the Federal Housing Administration and homeownership retention. The Administration's efforts to deal with this crisis have fallen short. The so-called HOPE NOW Alliance is clearly a failure. HOPE NOW states that it helped 545,000 homeowners in the last half of 2007, but 33 percent more homeowners actually lost their homes to foreclosure during the same time period. In addition, through January of this year, HOPE NOW servicers have been loathe to reduce interest rates or to otherwise modify loans that are unaffordable. Instead, 72 percent of the homeowners being helped by HOPE NOW are only receiving repayment plans.

Our current tactics, be they the Fed's monetary policy of reducing interest rates, or HOPE NOW's workout program, are simply

coming up short. Plummeting home prices have left many homeowners with negative equity, meaning they owe more on their homes than they are worth. According to Moody's Economy, 8.8 million homeowners, or 10.3 percent of all borrowers, are upside down on their mortgages. Goldman Sachs estimates that 15 million homeowners could be upside down by the end of the year. However, these families cannot refinance into more affordable or sustainable loans because of tighter lending standards and their lack of equity.

For months now, I have called on the Administration to do more to keep families in their homes. I agree with Chairman Frank that the time has come for the Federal Government to take a more active role in preventing foreclosures and rescuing our economy from the effects of mass foreclosures.

We have long recognized that FHA has the potential to assist families in staying in their homes. That is why we moved quickly to pass FHA reform legislation on September 18th of last year. The chairman's proposal would create a mechanism to get lenders and mortgage holders to work with FHA and FHA-approved lenders to write down the principal on a significant number of these unsustainable mortgages and allow families to benefit from a more affordable loan that is guaranteed by FHA. Using FHA as a tool for assisting homeowners to stay in their homes is a natural progression of the overall reform of FHA that Chairman Frank and I have been pushing since early in this Congress when I introduced H.R. 1852, the Expanding American Homeownership Act of 2007. I'm disappointed that the Senate failed to include a similar proposal to use FHA to write down mortgages in its housing stimulus bill.

The proposal put forth by Chairman Frank would give servicers a much-needed incentive to stop the wave of foreclosures currently overtaking our country. In today's market, servicers still have reasons to either let the property go into foreclosure or, as it is said, kick the can down the road and hope that homeowners can catch up on missed payments.

Under the chairman's plan, the lender or mortgage holder can have a bad loan removed from their books at a discounted price. Using FHA-approved lenders to buy these mortgages at no more than 85 percent of their appraised value would improve the poor decisionmaking of some servicers who still see foreclosure as their only alternative.

In addition, because FHA will guarantee these loans, the market and home prices will begin to stabilize. The family would get to stay in their homes with a mortgage they can afford, and the Federal Government could potentially make a profit on these loans if and when home prices begin to appreciate and the homeowner decides to sell.

Of course, I'm interested to hear the views of the witnesses on how this program would work in bulk. Chairman Frank has proposed allowing for a bulk refinance facility that would allow servicers to submit large numbers of loans to HUD, Treasury, and to the Fed for refinancing.

Let me just say that while I appreciate very much all of the effort that is going into the chairman's bill, I still have another bill that I think may be a bit more controversial, but it will help the

servicers to really do good mitigation. As a matter of fact, many of our financial institutions supposedly have mitigation departments, but when you call, you can't find a mitigator. You can't find anybody. So I have a mitigation bill, and the first thing in that bill, the first point of that bill is there has to be a telephone number, identifiable telephone number, that has been well-promoted, that the homeowners can locate and try and get some help with their mortgage before it goes into foreclosure.

Of course, my mitigation bill includes in it several other things that I think will be very helpful in determining whether or not real mitigation is going on. As I mentioned earlier, many of the servicers are doing these very limited, almost fake workouts where they say, "We will extend the payment." They are doing nothing to allow homeowners to do workouts that would allow them to continue the mortgage payments that they had when they got into the loan and before the ARMs reset.

And so having said that, it is just fair warning that while we have waited too long to really get tough on this issue, some of us are going to have to go beyond what would be considered even reasonable to force some real discussion on this issue and see if we can't get the Members of Congress so serious about this issue that everybody is prepared to fight as hard as they can to assist the homeowners who have been waiting for us.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from California, Mr. Royce, is recognized for 3 minutes.

Mr. ROYCE. Thank you, Mr. Chairman. This hearing of course is being held during a very troubling time for our housing sector, a very troubling time for our capital markets. And I think the potential wave of foreclosures will continue to threaten our economy until these troubled mortgages are restructured.

Because of the significant costs associated with a foreclosed property, we have a situation where the investors, the servicers, the lenders, and the borrowers all have an enormous monetary incentive to come to the table and try to restructure those loans. And to that end, much progress has been made since last fall. The numbers I have since March 3rd is that the 18 loan servicers, which are the biggest part of the HOPE NOW Alliance, that's two-thirds of the mortgage industry for both prime and subprime loans, have helped over one million homeowners, 1,035,000 people, rework their loans and stay in their homes.

Now if you look instead at the proposals being discussed here to empower the FHA to ensure a greater share of the outstanding mortgages, one of the concerns I have there is that this would transfer a lot of this risk—which is currently spread to investors all over the globe; institutions all over the world hold this risk, many institutions in Europe and many in Asia—onto the backs of the American taxpayers. And parties would be discouraged, in all probability, from renegotiating the terms of their contract through the HOPE NOW Alliance. In other words, if you're a lender or you're a borrower and you understand that rather than a reduction in the interest rate and restructuring that loan, there's the opportunity potentially to be bailed out. My concern is that takes the pressure off the servicers, off the borrowers, off the lenders to stay

at the table and work out the workouts that we have seen in over a million loans.

Also, the FHA and the CDBG, these are two government agencies which are expanded under the various proposals being discussed, and these are agencies that have struggled with mismanagement and improper uses of funds over the years and have cost the taxpayers billions of dollars in that regard.

So, in closing, we have a program that we know have helped restructure over a million loans. We have raised the conforming loan limit for the GSEs through the end of the year. The Federal Reserve has lowered the Fed Fund's rate by 300 basis points, which continues to provide more needed liquidity to the market, and I believe Congress should avoid undermining the progress being made. We should do more to encourage those lenders and servicers and borrowers to get to the table, but we should allow those actions to play out rather than pull the rug out of the incentives that we want to create there and instead send a different message, a different message to the market to pull back away from those agreements and instead wait to see if you can have a bailout. I think that is a bad policy. I look forward to hearing from our panel of witnesses today, and I yield back the balance of my time.

The CHAIRMAN. The gentlewoman from New York, the chairman of the Financial Institutions Subcommittee, is recognized for 2 minutes.

Mrs. MALONEY. Thank you. I welcome this hearing and support this very necessary legislation. New problems in the economy are popping up like a not very funny version of whack-a-mole, as Alan Blinder, a former Vice Chair of the Fed, recently observed, who will be testifying on the second panel.

The decline in home prices is causing banks to readjust their balance sheets and to build up capital, which is at the core of the liquidity crisis. Economists warn that containing financial volatility will be difficult until housing prices stop falling, which is why Congress is working on solutions to keep people in their homes and avoid a deep downturn.

The Administration says it wants to use the FHA to help people and to help homeowners, too, but to date, the Administration's plan, FHA Secure, has helped fewer than 3,000 people, a tiny and inadequate drop in the bucket. Today we learned that the Administration plans to expand FHA Secure without, they say, any investment of government funds. But to me, their math just does not add up. I have serious questions as to how substantially more homeowners can be helped through the FHA without an infusion of government funds. And I refer to an article in the Wall Street Journal that outlines this new program.

The crisis in the housing market has brought to light the inability of our most sophisticated and respected institutions to measure their exposure to opaque assets, and more importantly, to manage the risk associated with them. The Federal Reserve has recently come under fire for making a $29 billion line of credit available to J.P. Morgan Chase to acquire the investment giant Bear Stearns. This action to head off a sudden collapse of one of the Nation's largest investment banks very likely prevented widespread finan-

cial panic, and a potential domino effect among other financial institutions.

Now that we have helped Wall Street, I believe it is time that we help Main Street. And we have a bill, an important bill before us today that does just that.

I just wanted to mention—I would like to reference a report on the need to have helped Bear Stearns, and I will put it in the record without any comment.

But just finally, we need to move quickly to keep families in their homes and to blunt the devastating effects of this weakening economy.

The CHAIRMAN. The gentleman from Texas is recognized for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman. I fear the bill before us may offer short-term gain to a few and promise long-term pain to many. We all know that there has been an economic wreck in our housing market. And as a Nation, the sooner we can clear away the rubble, the sooner that we can rebuild this market. However, that is unlikely to happen, as many borrowers and lenders and investors and trustees all sit on the sideline awaiting their expected congressional bailout.

I mean, why should anyone help clear away the rubble that they may have helped cause if somebody else can be forced to do it for them, namely the U.S. taxpayer. And we cannot legislate away losses as much as we would like to. But apparently, we can redistribute them. And I fear that is the thrust of the bill that is before us today; putting taxpayers at risk for over $300 billion, which could be equivalent to a tax increase of at least $2,000 per American family. Now this is on top of the tax increase that American families will see that was included in the last budget passed by Congress, which is roughly $3,000 per family.

This bill can also exacerbate even a greater crisis, and that is the spending crisis which CBO, OMB, and GAO all say threatens the next generation with a tax burden double our own, meaning that there could be fewer housing opportunities for future generations. Again, short-term gain for some, long-term pain for many.

This bill has many interesting features, not the least of which is that it will clearly help bail out Wall Street as investors quickly dump their worst performing assets on taxpayers, yet it will ignore much of Main Street, those who paid off their homes, those who rent their homes, or those who made prudent decisions not to buy more home than they can afford; in other words, 98 to 99 percent of America.

The most important policy decisions we could make to help the housing market would be to forestall the automatic huge tax increases that are in the system, bring certainty to the marketplace, and lower capital gains tax rates to add liquidity to the market.

I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman from Georgia is recognized for 2 minutes.

Mr. SCOTT. Thank you, Mr. Chairman. This is indeed a very timely and an important hearing, and I think that just to set it in its stark reality, we are faced, ladies and gentlemen, with the worst economic crisis, particularly in terms of liquidity, since the Great

Depression. And we need to face this urgency with that stark reality.

One of the examples that we moved very swiftly with in terms of helping Bear Stearns, that was important logic. That was important to do. But we need to apply that same logic to helping homeowners and families. And that logic was this. If we failed to help Bear Stearns, it would have had a cascading effect. We are the leading financial world market in the world here in the United States. If we had not worked very vociferously in the government with a strong arm to come in and to save Bear Stearns, there would have been a worldwide collapse.

Well, that same logic must apply to home mortgages and families. And it's particularly true because within the next 3 or 4 years, there are going to be about 2 million mortgages that are going to be reset because of these teaser rates, and these adjustable mortgage rates are going to be reset, and that's going to have a very serious, calamitous effect on the economy.

So this move, this bill, is very important. FHA is at the centerpiece of it. It's very important that we move forthrightly and deal with this housing and mortgage crisis with the urgency that we moved with Bear Stearns. To do otherwise would be forfeiting our great responsibility to the American people. And the American people are watching to see if we apply the same logic. If it works for Bear Stearns, then it ought to work to help American families and homeowners.

Thank you, Mr. Chairman.

The CHAIRMAN. We are running out of time on this side, but we will accommodate the last three members for 1 minute each, but we are going to have to hold to that. The gentleman from Texas, Mr. Neugebauer, for 1 minute.

Mr. NEUGEBAUER. Thank you, Mr. Chairman. Several points have been made that I would make, but what I would say is that we have to be very careful that we make policy in this country that starts picking winners and losers. Many people have suffered the devaluations of their stock portfolios, but it's not the role of government to come in and make sure that everybody makes a profit, nor is it the role of government to make sure that everybody's home value goes up.

A lot of people are currently making their mortgage payments today all across the country and the value of their homes has gone down. What the marketplace is really waiting for Congress to do is get out of the way. How we got to the highest homeownership in the history of country was not because the Federal Government was providing opportunities for people to own homes. It was because the marketplace was providing opportunities for people to own homes, and we had a financial market that was financing those.

One of the things that we cannot do is take people and create equity for them. That is not the role of government, nor do the American taxpayers who have been paying their mortgage payments, who bought their homes at a certain time, think it is fair that now because they bought theirs last year or 2 years ago, that somehow the Federal Government now is going to make these new homeowners whole. And so I think we're going down a very slip-

pery slope here, and I would hope members would give serious consideration to what we are doing here.

Thank you.

The CHAIRMAN. I apologize, but, you know, it's 20 minutes that's coming out of other members' time on your side when we do this, because we're already slightly over, frankly. The gentleman from Texas, Mr. Green, for 2 minutes.

Mr. GREEN. Thank you, Mr. Chairman. Mr. Chairman, there are many who conclude that we're in this crisis because of some of the deregulation that took place in the 1980's, which allowed exotic products such as 3/27s and 2/28s to come into existence. And as a result, there are persons who conclude that we ought to have some hand in trying to make whole or make right the circumstance that we in part created.

I believe that this plan, as I have viewed it, is voluntary, and it does not require that institutions who hold loans do certain things. It merely gives them an inducement to do things that can be of benefit to the consumer, who happens to be the borrower. In my district, I hear hue and cry from persons who are concerned about this issue, and they are indeed asking that Congress get involved and do something to help prevent this crisis from becoming an even more severe crisis. We're talking about the possibility of a recession. There are some people who are already living in a depression.

I yield back the balance of my time.

The CHAIRMAN. The gentleman from California, Mr. Miller, for 1 minute.

Mr. MILLER OF CALIFORNIA. Thank you very much. There is no doubt that we are facing a severe liquidity problem today. Every housing recession I have experienced has been a little different. The mid-1970's was one way, the 1981 recession, prime went to 21 percent. You could get money, you just couldn't afford to borrow the money. The recession of the 1990's, very difficult recession also. And I guess it's a housing recession if your house is in foreclosure. If it's not, you aren't that concerned about it.

The biggest problem we have today is liquidity. We have to do something to create liquidity within the marketplace, and that's the whole purpose of GSEs to begin with, to make sure we do have liquidity. I think we made a right move and we need to make it permanent in raising conforming loan limits in high-cost areas, FHA, Freddie Mac, and Fannie Mae, those are hugely important to getting the market to turn around.

I don't understand the bulk refinancing programs proposed in this bill. I need to talk to the chairman about that to understand. I am kind of concerned about that a little bit. I don't know also how we impact the market if we're taking 85 percent of what the home is worth in the market value. Does that somehow in the future impact appraisers when they're going out appraising the market value of a home? Is the appraiser going to say, well, the market value should be 500 but it's now 425, because that's what lenders are taking to pay off the debt? I don't know those answers to those questions, but I think it is something we have to get to.

Thank you.

The CHAIRMAN. I thank the gentleman. The final 1 minute goes to the gentleman from California, Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman. Mr. Chairman, you referenced a coincidence with the Bush Administration yesterday. I think there was another coincidence yesterday, which was the information that apparently Citibank may have reached a deal with private equity firms to buy $12 billion of their troubled loans. And it raises for me three questions here, which I hope to ask over the next 2 days as we have these hearings. One is, who are we bailing out here? Are we really bailing out truly disadvantaged troubled homeowners, or are we bailing out Citibank? Are we adding advantage to private equity firms? What are we doing here?

Second, how do we avoid adverse selection if we are offering to have the FHA to take over certain loans? And third, is this kind of—I would say secondary, except it's really kind of a third tier market for these troubled mortgages developing already as we saw yesterday with some private equity firms.

And so with that, I yield back, Mr. Chairman.

The CHAIRMAN. I thank the gentleman, and we will now begin with our panel. Let me say as we begin that I am very grateful, especially to our colleagues in the bank regulatory area. I don't want to put words in anybody's mouth, and people have their own independent views, but every one of the agencies represented here has been very helpful. And without signing on in principle, we have found both the public and private comments and the availability of the staffs of all the agencies very helpful. Because I think there are a number of ideological issues, there are some practical issues, and I am very grateful to the staffs of all the regulatory agencies and to the heads of them for making them available so that we can come together. And I will say that there are comments that were made by all the regulators that, frankly, before we began to put this bill together I think you will find much of what you said reflected in the bill, not always necessarily the way you like it, but then, as we age in particular, we are not always entirely pleased by our reflections, but they are nonetheless our reflections.

We will begin with the Chair of the Federal Deposit Insurance Corporation, Ms. Bair.

STATEMENT OF THE HONORABLE SHEILA C. BAIR, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Ms. BAIR. Thank you, Chairman Frank, Congressman Miller, amd members of the committee. I appreciate the opportunity to testify today.

The problems we face in the housing and credit markets were caused by a very complex set of interrelated events. Steps taken to date have helped, but more proactive approaches are needed to stop the escalation in foreclosures and to restore stability to housing markets. We do need more intervention, and to be honest, it will probably cost some money. No single solution can fully address the problem. Resolving these issues will require a number of strategies for the different segments of the mortgage market.

The FDIC has aggressively advocated systematic, voluntary loan modifications to deal with millions of unaffordable loans, particularly in the subprime market. While significant progress has been made, it must be acknowledged that the pace has been too slow to

achieve the scale necessary to contain broader harm to communities and our economy.

I think all of us are painfully aware of the extent of the damage and the ongoing effects on virtually every State in the union. So in the time remaining, I would like to make a few comments about the pending legislation.

The proposal by Chairman Frank addresses many of the principles the FDIC considers necessary for an effective program. It converts troubled mortgages into loans that should be sustainable over the long term and convertible into securities. It requires that investors recognize current losses, while preventing borrowers from being unjustly enriched if home prices appreciate. It uses existing government and market structures, which should allow the program to be implemented more quickly. And the legislation provides a financial cushion in the program to help insulate the Federal Housing Administration and taxpayers from losses.

Still, there are some specific issues that need to be addressed, we feel. A major obstacle to refinancing many troubled first mortgages is that a significant percentage of them are subject to second liens. Resolving this issue is essential to ensuring the effectiveness of any proposal.

A second concern is whether the FHA, at least in the short term, will have adequate capacity to run the program.

Third is the unintended consequence of promoting adverse loan selection, which could increase the potential of losses for the program.

And a final issue, which Chairman Frank already mentioned, was the incentives or lack of incentives for servicers to modify loans. The reality is that the success of this proposal in achieving scale restructurings depends on servicers devoting significant resources to writing down these loans.

In my prepared testimony, we have made suggestions for addressing many of these issues. These include holding back a certain portion of refinancing proceeds which would then be released to investors and servicers over time, depending on the continued performance of the loan.

The FDIC supports long-term solutions that fairly share the costs and risks of modifying or restructuring loans that use existing government market systems and that mitigate the potential exposure to taxpayers. The FDIC is committed to working with this committee and others in Congress to find the right combination of strategies to stem the rising tide of foreclosures and corresponding declines in home values.

I think all of us share the goal of restoring health and vibrancy to mortgage markets and to repairing the damage done to America's promise of owning a home.

Thank you very much.

[The prepared statement of Chairman Bair can be found on page 94 of the appendix.]

The CHAIRMAN. The Comptroller of the Currency, Mr. Dugan.

STATEMENT OF THE HONORABLE JOHN C. DUGAN, COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. DUGAN. I appreciate the opportunity to testify today concerning the draft FHA Housing Stabilization and Home Ownership Retention Act of 2008.

Today's hearing takes place in the context of broad efforts by the government, the industry, and community organizations to respond to challenges presented by rising rates of foreclosure. The Act would establish a new program that would provide a distressed borrower who could no longer afford his or her mortgage and the holder of the mortgage with an alternative to the costly prospect of foreclosure.

This program has three key elements. First, if the borrower and mortgage holder agreed, and the borrower met certain criteria, the mortgage holder would reduce the mortgage principal to an amount that would be affordable for the borrower. Second, the mortgage holder would accept the corresponding loss. And third, the mortgage would then be refinanced into a new FHA-insured mortgage product at the lower amount.

The concept is that the alternative would be less costly than foreclosure for many such loans, which would be the incentive for mortgage holders to agree to it; that it would allow borrowers to remain in their homes with lower mortgage payments, which would be their incentive for agreeing to it; and that the written-down mortgage would be an acceptable risk for the government to assume in order to lessen the prospect of widespread foreclosures and all their related costs.

Because the program is voluntary, the Act could be a useful new tool, and safety and soundness considerations for banks would be manageable. Each bank or mortgage holder could evaluate the range of risks and benefits of the new program relevant to its particular situation.

If the option proved to be an attractive and less costly alternative to foreclosure, as intended, it could save national banks significant amounts of time and money, and benefit their borrowers and their communities. The pivotal question is the extent to which borrowers and mortgage holders would actually choose this new voluntary option. This will depend on a potentially complex mix of factors.

On one hand, the direct cost of foreclosure is steep in most cases, with lenders' and investors' losses on foreclosure typically in the range of 40 percent, although this number can vary. On the other hand, depending on particular circumstances such as the amount of home price decline and the borrower's documented income, the direct cost from exercising the program's refinancing option may also be steep. We include a number of specific examples in our written statement to show that in some very plausible circumstances, exercising that option may or may not be less costly than foreclosure.

Another variable is the extent of payment shock faced by some borrowers with adjustable rate mortgages, or ARMs. Initial fixed interest rates on hybrid ARMs reset to higher variable rates, but these rates have recently declined as key ARM interest reference rates dropped sharply this year. Thus, more ARMs may be afford-

able than previously envisioned so long as interest rates remain low.

Nevertheless, recent property value declines have left many borrowers owing more than their houses are worth, sometimes referred to as negative equity. Foreclosures are still up, and it appears that negative equity is contributing significantly to that problem.

Where second mortgage holders are present, refinancing under the new program faces additional challenges. As I explain in my written testimony, when a borrower has insufficient equity in his or her home to cover first and second mortgages, the second mortgage holder's objectives and incentives are very different from the first mortgage holder. This suggests that it will be essential to understand the concerns that second mortgage holders have and to identify incentives they regard as workable. The existence of private mortgage insurance further complicates matters.

In conclusion, I would note that designing incentives that balance the needs of borrowers, lenders, and investors is a very complex and delicate task. There is no easy solution, and we have made suggestions in our written statement to address some of the issues we have identified.

At the end of the day, the more constructive the options that stakeholders have to address the prospect of foreclosure, the greater the chance that homeowners can remain in their homes.

Thank you very much.

[The prepared statement of Comptroller Dugan can be found on page 123 of the appendix.]

The CHAIRMAN. Next, the Director of the Office of Thrift Supervision, John Reich.

STATEMENT OF THE HONORABLE JOHN M. REICH, DIRECTOR, OFFICE OF THRIFT SUPERVISION

Mr. REICH. Good morning, Chairman Frank, and members of the committee. I appreciate the opportunity to testify on how to turn back the rising tide of home foreclosures in America, and particularly to offer the views of the Office of Thrift Supervision on the FHA Housing Stabilization and Home Ownership Retention Act of 2008.

I would like to commend you, Mr. Chairman, for your diligence and leadership on this important subject, and also to thank you for the cooperative approach and exchange of ideas that my staff has had with yours as we and others work towards this essential common goal.

In my comments, I would like to share a few thoughts about loan modifications, and then speak to the similarities and the points of departure between the OTS foreclosure prevention proposal and the FHA Housing Stabilization and Home Ownership Retention Act, which I will refer to as the chairman's bill.

Regarding loan modifications, the data that we are seeing confirms that the sheer volume of foreclosures is overwhelming normal resolution channels. In addition, foreclosures are reducing the prices of other homes in affected neighborhoods, creating a cascading problem. We are at a crossroads in addressing the combined

effects of reduced home prices and the next wave of rate resets for subprime, 2/28, and 3/27 mortgage loans.

About 1.3 million American families have subprime mortgages that are scheduled to reset by the end of 2008. Despite a decline in interest rates, foreclosures among subprime borrowers holding these types of mortgages are expected to continue to rise.

Although some loan modification programs have been reasonably effective, more needs to be done, and soon. That being said, any solutions must preserve the integrity of the broader mortgage markets. Although some might argue that these markets fuel speculative and unsafe mortgage lending, many U.S. consumers own homes solely because of favorable mortgage rates and terms received through the efficiency of the U.S. capital markets. We must ensure that efforts on behalf of consumers who entered into bad deals do not compromise the greater collective interest of all consumers for affordable housing finance.

Regarding the chairman's bill, and the OTS foreclosure prevention proposal, both seek to preserve homeownership and prevent foreclosures through the use of the new FHA-guaranteed loans based on the current fair market value of the property.

As we have met during recent weeks with major servicers, investors, and fellow regulators about the OTS proposal, we have done some fine-tuning in some ways that has brought our proposal closer to the proposed legislation. For example, we now think that it makes sense for borrowers to share in the potential upside when their home appreciates in value in the future as an incentive not only to remain in the home, but to maintain it as well, and even make improvements to get the best possible price upon resale.

However, we still think that the key to success for this approach is for the loan servicer to have enough incentive through a stake in the future upside potential to be moved to action to save the home from foreclosure. If the servicer, acting on behalf of the original loan holder, does not have sufficient incentive, then no action will be taken, more homes will be lost to foreclosure, and this crucial foreclosure prevention effort will fall painfully short of the mark.

In another example of fine-tuning the OTS proposal, we originally proposed the new FHA loan be at almost 100 percent of the fair market value of the home. We now believe that there is merit in lowering that amount to minimize risk to the FHA. However, if the holder of the loan takes this bigger haircut up front, it makes all the more sense to provide a potential share of the upside down the road.

While we do not think that using FHA as a financing vehicle to prevent foreclosures will be the silver bullet that stops the housing slide, we do think that it is an important additional tool that lenders can use to stem the rise in foreclosures.

Thank you again for having me here today, Mr. Chairman. I look forward to your questions.

[The prepared statement of Director Reich can be found on page 165 of the appendix.]

The CHAIRMAN. Thank you, Mr. Reich. And you accurately reported the degree of cooperation between the staffs, as is the case

also, and we are very grateful to the Federal Reserve System, and we welcome Governor Kroszner.

STATEMENT OF THE HONORABLE RANDALL S. KROSZNER, BOARD MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. KROSZNER. Chairman Frank, Ranking Member Bachus, and other members of the committee, I am pleased to be here to discuss the efforts to address current problems in the mortgage and housing markets, including some aspects of the discussion draft of the FHA Housing Stabilization and Home Ownership Retention Act of 2008.

The mortgage market has long been a source of strength in the U.S. economy, but it is facing very significant challenges today. Both delinquency and foreclosure are dramatic experiences for the families and communities who are affected. Recent declines in house prices have eroded the equity that homeowners have in their homes, and this has made it difficult or impossible for many of them to be able to refinance their mortgage. Tighter lending standards have also limited opportunities for these families to refinance.

Moreover, when struggling homeowners cannot put themselves on a sustainable financial footing, neighborhoods also suffer because the properties are not maintained and because foreclosure puts further downward pressure on housing prices.

The fact is that many borrowers having trouble making payments also have mortgages that are underwater, that is, have negative equity. This suggests that principal reductions can be an appropriate option in a loan modification toolkit. In the discussion draft, principal reductions would be facilitated by providing the FHA with the flexibility to ensure a broad range of refinancing products for a larger number of at-risk borrowers.

The voluntary nature of the program assures that not only borrowers whom the servicer believes cannot successfully carry their current mortgage contracts would be considered for such a program.

If the Congress decides to move down this road, it should carefully consider five very important issues:

First, mitigating moral hazard. Homeowners who can afford to pay their current mortgage should not be encouraged to default in order to qualify for a write-down.

Second, mitigating adverse selection. A robust defense against adverse selection, that is, the incentive of current servicers or lenders to send only their worst credits to government-insured mortgage programs, is necessary to protect the interests of the taxpayer.

Third, turning the FHA into a world-class mortgage insurer. With modernization and expansion, the FHA could play an important role in relieving stress in the mortgage and housing markets as well as restarting the securitization markets.

Fourth, protecting the taxpayer. Any government-insured mortgage offered under a refinance program needs to be prudently underwritten, regardless of whether the principal write-down is part of the deal or not. First and foremost, this means establishing a meaningful amount of homeownership equity. Second, it means

using sound underwriting criteria to ensure that borrowers are reasonably likely to be able to repay the government-insured loan on a sustainable basis. Third, it means allowing the FHA to engage in sensible risk-based pricing of its mortgage insured products, including substantial flexibility in setting its initial premium and annual premiums.

Fifth, negotiating the junior liens. Typically, the junior lien holder must agree to remove his lien in order for a portion of the proceeds from the refinancing or resubordinate his claim to the new loan. The valuation of the junior lien holder's claim on the property is often very difficult to renegotiate.

Elements of these considerations are already reflected in many parts of the discussion draft. For example, Title 1 of the discussion draft includes exit fees, shared appreciation mortgages, and a relatively high debt payment to income ratio before the program starts in order to address concerns about borrower moral hazard.

It also contains features to protect the taxpayer, such as widening the range of insurance premiums and creating a meaningful amount of borrower home equity. As for adverse selection, the risk-based insurance premiums paid by the servicer are crucial, and Title 1 could be clearer about the FHA's authority to use risk-based premiums.

Other steps to guard against adverse selection could include adding a loan seasoning requirement, that is, for example, a period during which a new loan could be sent back to the original servicer or lender if it redefaults, and a fee structure that imposes costs on the original servicer or lender if the new government-insured loan goes bad within a specified period or probationary period.

In the design and details of a principal reduction program based on a government-insured refinancing, it is critical to strike the right balance between the interests of borrowers, servicers, investors, and taxpayers by seriously considering the issues I have outlined above.

Moreover, although principal write-downs may be especially germane today given the prevalence of negative equity positions, they are not necessary or appropriate for all borrowers who have negative home equity or who become delinquent on their mortgage.

Given the magnitude of the potential foreclosures on the horizon, Congress should carefully evaluate whether to take additional actions to reduce the rate of preventable foreclosures. Properly designed, such steps could promote economic stability for households, neighborhoods, and the Nation as a whole.

Thank you very much.

[The prepared statement of Governor Kroszner can be found on page 144 of the appendix.]

The CHAIRMAN. Thank you, Governor.

And finally, the Commissioner of the Federal Housing Administration, Assistant Secretary Brian Montgomery.

STATEMENT OF THE HONORABLE BRIAN D. MONTGOMERY, ASSISTANT SECRETARY FOR HOUSING-FEDERAL HOUSING COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. MONTGOMERY. Thank you very much, Mr. Chairman, and Ranking Member Bachus, for inviting me to testify this morning.

Mr. Chairman, I want to say that we are aligned in our goals for addressing this mortgage crisis. We agree that we must restore liquidity to the credit markets and stability to the real estate markets.

We agree that there is an appropriate role for the government to play, and that we must use government resources wisely. And we agree that we must help families in need without transferring risks and costs from the private sector to taxpayers.

As you well know, for more than 2 years, the Administration has requested FHA modernization legislation to prevent the very circumstances in which we now find ourselves. And I want to reiterate that it is even more critical now that this bill be enacted.

I am grateful for the support that you, Ranking Member Bachus, and bipartisan majorities of this committee have given to this important legislation. And I would urge you, I would ask you, to quickly reach an agreement with the Senate so the final bill can be sent to the President's desk.

As you have heard previously, Mr. Chairman, there are two key components that must be part of the final bill. To ensure the future solvency of the FHA fund, the legislation must permit risk-based premiums, and it must prohibit seller-funded downpayment assistance. Foreclosures on these loans are 3 times as high as loans for borrowers who make their own downpayments. We can no longer sustain the mutual mortgage insurance fund without an appropriation if we do not address these problems.

Now, while modernization should be the highest legislative priority, expanding the FHA Secure program administratively is the most appropriate and fastest means to help more families in need. As you know, we have been exploring options, and I would like to share the Administration's plan.

We believe it is appropriately tailored to reach homeowners who have demonstrated their commitment to making on-time payments, even during times of financial stress. I want to emphasize that we believe it is critically important to focus on those homeowners who are working hard to fulfill their obligations.

FHA will now back loans for borrowers who are financially capable, but who have a spotty credit record. To qualify for a standard 97 percent LTV loan, borrowers will still be eligible if they were late on two monthly payments, either consecutively or at different times over the previous 12 months.

For borrowers who cannot meet this standard, FHA will permit up to 3 months of delinquency, but FHA will limit the LTV ratio for these borrowers to 90 percent. We will permit and we will encourage lenders to voluntarily write down outstanding principal.

Lenders will also be allowed to make other arrangements, including new subordinate liens, to fill the gap between an existing loan balance and the new loan amount, be it a 97 percent or a 90 percent LTV loan.

These underwriting changes will also be coupled with a new and more flexible pricing policy at FHA. As you know, the FHA program is funded through insurance premiums that homeowners pay themselves. And we are rolling out a new pricing plan that will base new premiums on an individual's risk profile.

This new administrative change will ensure the integrity of the FHA insurance fund over the long term, it will protect the taxpayer, and it will guarantee that FHA will be around in the future to help struggling homeowners. We believe that by year's end, this new version of FHA Secure will reach more than half-a-million homeowners. This figure represents a substantial portion of the total universe of homeowners with subprime ARMs who are owner occupants, have documentation to demonstrate their ability to repay the loan, and who are not already in foreclosure.

While I believe that these actions are consistent with parts of your proposal, I want to point out some areas where we do not agree.

The mandatory write-downs remove any ability of a subordinate lienholder to negotiate a short payoff, and would severely restrict the number of lenders and borrowers who would participate. A simpler approach, more in line with existing market practices, we believe, would be more effective.

Underwriting standards should also not be set in statute, and we don't believe the current proposal is sufficiently targeted. It mandates a loosening of the underwriting criteria that could also saddle FHA with too much risk. For example, the proposal would have lenders disregard some underwriting criteria, and allow borrowers with much higher debt to income ratios to be eligible. Preserving our administrative flexibility to help homeowners and protect taxpayers is critically important.

The Administration also strongly opposes the $10 billion in loans and grants for the purchase and rehab of vacant and foreclosed homes. The principal beneficiaries of this type of plan will be private lenders who are now the owners of the vacant or foreclosed properties.

Finally, we do not support proposals to create a system where lenders would have an opportunity to sell bad loans to FHA and to the taxpayer through an auction process, a clearinghouse, or some other wholesale mechanism. We do not believe that it is necessary to encourage mortgage holders to sell portfolios at a discount to new investors. The market does not need a government entity to play this role.

Again, Mr. Chairman, and Ranking Member Bachus, while we disagree with some components of the bill, other elements are similar to the expansion of FHA Secure. These are my thoughts on the bill. I again stress that our common ground can be used to help FHA become a safe harbor for many more Americans, and I look forward to working with you on this committee. Thank you.

[The prepared statement of Assistant Secretary Montgomery can be found on page 160 of the appendix.]

The CHAIRMAN. Let me begin with that, Mr. Montgomery. You are right, there is some common ground. In particular, as I understand it, you are going to use your administrative authority to

broaden the universe of people who can come to the FHA, and they would be people who had defaults.

You are also agreeing that we should be asking the servicers or telling the servicers that were they to write down the principal, then the FHA would take on, I think it is fair to say, a greater degree of risk than before.

Now, you have heard several members of the committee today be very critical of this notion of the taxpayers being at risk. What you are talking about is an FHA guarantee. How do you respond to the criticisms we have heard that we should not be at this right now?

Again, these are people who, to quote some of the members today, borrowed more money than they can pay back. And we agree with you, we should be asking the holders of those loans to write them down, and we should let them into the FHA and give them a federally taxpayer-based guarantee more than we would have in the past. We would differ about how much.

How do you respond to the criticism that this is putting taxpayers' funds at risk for people who had imprudently borrowed?

Mr. MONTGOMERY. That is precisely what we don't want to do, put taxpayers at risk. FHA is an insurance fund, sir, as you know. We have to balance the risk characteristics of all of our borrowers, and we want to be able to help borrowers in the future. There is a family somewhere in—

The CHAIRMAN. Mr. Montgomery, let's not filibuster. I understand we want to help people in the future. We all want to do a lot of things. How do you answer the criticism that by expanding the eligibility so that people who have mortgage loans they cannot now make, we ask that they be written down in the principal. They now come to the FHA, and you are now going to extend an FHA guarantee, according to the announcement of yesterday, to people who hadn't previously been eligible because they had a default, etc.

How do you answer the argument that this is taking people who borrowed imprudently, giving the lender an incentive to relax it, and then giving them a Federal guarantee?

Mr. MONTGOMERY. Yes. The point I was getting to, sir, is that 90 percent LTV loans in the FHA's portfolio perform very well. In going forward, whatever a lender and whatever the current borrower want to agree to, if they are underwater, as long as they don't have more delinquencies than I have outlined before, I am saying today FHA, assuming they pass our underwriting criteria, will step in and take 90 percent of that—

The CHAIRMAN. I understand that. You are just repeating it. But does that not expose us to greater risk than we were before you announced this program?

Mr. MONTGOMERY. Look, there were borrowers who had no-doc loans, low-doc loans. Many of those—

The CHAIRMAN. Mr. Montgomery, please just answer my question.

Mr. MONTGOMERY. I am answering. Many of them will qualify.

The CHAIRMAN. No, you are not. Does this change, which expands the eligibility, waives some of the objections on default—does it expose us to people who are riskier than previously we had taken into the FHA program?

Mr. MONTGOMERY. Yes. Yes, sir, it does.

The CHAIRMAN. It does. Thank you.

Mr. MONTGOMERY. Yes.

The CHAIRMAN. Okay. That is the answer. And I appreciate your doing that. I think it is appropriate. But while there are some differences, we are in agreement that the current crisis calls for a greater risk tolerance on the pat of the taxpayer, which puts some taxpayer funds at risk, and the beneficiaries of that greater risk tolerance are going to be people who borrowed more than they should have.

Let me just ask Governor Kroszner now, because one of the criticisms that we have heard was on this federally funded mechanism, essentially the notion that we should have in the bill, as we do, an auction mechanism. That is actually something, as you know, Governor, that we discussed with the Federal Reserve.

You mentioned it favorably in your testimony. Would you explain why you think that would be a useful option for us to have an auction? Let me say, and I have drawn this from Chairman Bair, the problem with the original approach was that you do these loans one at a time. I mean, FHA Secure has done about 2,400 loans. We are talking about a very long time before they are done.

There are a couple of things about the auction mechanism. One is a price-setting, but also, it allows you to move more than by onesies and twosies. But I wonder if you would address that issue about the desirability of that as an option, Governor Kroszner.

Mr. KROSZNER. Sure. Thank you, Mr. Chairman. If Congress is concerned that a loan-by-loan approach will not address the problem sufficiently, it certainly could consider adding what is in Title 2, and the ability to expand the program quite significantly so that it could operate on a larger scale.

If properly structured, and of course this is going to be very difficult to address all of the concerns of moral hazard, protecting the taxpayer, adverse selection, in developing such a mechanism, it could have the potential to mitigate some of the turmoil in the housing market.

And so, if you do decide to go ahead on this, it is very important that the agencies that are given the ability to implement this have the full latitude of such authority and a great deal of flexibility to do the implementation.

The CHAIRMAN. Thank you, and my time is expired. I am going to hold members to time. We have a lot of members, a lot of witnesses, and a lot of interest.

The ranking member, the gentleman from Alabama.

Mr. BACHUS. Thank you. I appreciate your testimony here this morning. And Chairman Bair, I thought on page 2, your paragraph about the complex set of interrelated causes was a very succinct and very accurate description, at least in my opinion, of what happened leading into this. And it—well, I will just say that. I won't go into more detail.

I appreciate everyone's testimony. I thought it was all very thoughtful. And Mr. Montgomery, I want to commend you for streamlining FHA and making it more user-friendly. You have heard a lot of compliments from both sides of the aisle about that process, and I thank you.

Governor Kroszner, let me ask you the first question. I read in the Wall Street Journal where Senator Clinton had compared our present situation—equated it to the lost decade in Japan, the Japanese economy of the 1990's. It is getting a lot of currency recently.

I don't see that. I think it is just the opposite. I think that the banks are being aggressive in writing down their losses, that the regulators are being responsive. You are supplying liquidity. I don't think the banks or the regulators are in denial.

But what are your thoughts on that? Is that, in your opinion, accurate?

Mr. KROSZNER. I think the various government entities have taken a much more aggressive stance in the United States than Japan did during their lost decade. I mean, just for example, the Federal Reserve alone has cut interest rates by 300 basis points. We have provided a great deal of liquidity to the financial system through traditional and new mechanisms, providing liquidity to longer term, taking a larger number of—different types of collateral, and expanding the number of types of institutions that could borrow from us.

Firms have been much more aggressive now than they were in Japan in writing down the problem loans. We have seen tens of billions, literally hundreds of billions of dollars of write-downs that have occurred in the last 6 months alone. We didn't see that in Japan for many, many years.

And also, the Congress was able to, and the Administration was able to move very quickly with a targeted fiscal stimulus package. I think all of these are very different kinds of responses in the last 6 months to this turmoil than we saw in Japan during their lost decade.

Mr. BACHUS. Thank you. I think they are very different, too. I think they are comparing two very different situations. So I agree with your response.

Commissioner Montgomery, today—and this is the Wall Street Journal again; I do read things other than the Wall Street Journal, by the way, but I will just use it as kind of a basis of the question—they said "The expansion of FHA Secure will be funded by risk-based premiums rather than up-front cost, between $10 billion and $20 billion in Chairman Frank's plan." So that is not me. That is at least—

The CHAIRMAN. That is the objective Wall Street Journal.

Mr. BACHUS. Yes. But can you explain the difference? Is that a valid comparison? Explain the difference between the funding mechanisms for the Administration's plan versus Chairman Frank's plan?

Mr. MONTGOMERY. Well, going forward, we think our premium structure, as Governor Kroszner also said, needs to be based on risk. This is not a new concept. It is something we have been discussing for 2 years.

I am going to tie in the seller-funded downpayment for one second because that is what is driving us to the brink of financial insolvency. We cannot continue to accept that without having some flexibility in our pricing. Now, we think we can do this proposal administratively, going to our statutory limit of 2.25 on the up-front premium.

I understand the chairman's proposal would go to 5 percent for those borrowers. That is something that we can certainly discuss going forward if it means in an actuarial standpoint that we could help more borrowers. Certainly that is on the table. I am just bound to what my current constraints are on premiums.

Mr. BACHUS. So this would be paid for by premiums?

Mr. MONTGOMERY. We are a self-sustaining agency. We take no taxpayer funds except to pay our salaries and expenses.

Mr. BACHUS. Will all homeowners, through the payment of higher premiums, will they all pay more for the default of a few? Many on this side of the aisle, you heard this morning—

Mr. MONTGOMERY. I am going to say—I am sorry, sir, but I am going to say, going forward, a lot of the borrowers—remember, these are not FHA borrowers. These are subprime borrowers who have defaults.

Mr. BACHUS. Well, yes.

Mr. MONTGOMERY. It is safe to say many of them would pay at the higher range of that 2.25. But going forward, some purchase borrowers may also realize a small discount that they would not see today.

Mr. BACHUS. So if they have a good credit history—

Mr. MONTGOMERY. Yes, sir. That is correct.

The CHAIRMAN. The gentleman's time has expired.

Mr. BACHUS. Thank you.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you very much.

Chairman Bair, I want to focus on the servicers. They are kind of in the driver's seat here. We have been talking a lot about them, and I think you mentioned something about incentives. I am not clear because I have heard that the servicers actually earn a profit on foreclosures. And then I am hearing that in order to foreclose, it costs so much money that you lose a lot of money on foreclosures.

I want to know, what do you know about the truth in all of this, and what other kinds of incentives do the servicers need to do modifications? We are told we can't interfere with that contract that they have with the investors. So what other kinds of incentives do we have to get them to do real modifications?

Ms. BAIR. Well, in terms of incentives for foreclosure versus modification, most of the pooling and servicing agreements that we have looked at will provide for servicer reimbursement for administrative costs associated with foreclosure. They should not be making a profit, but they do provide for reimbursement from the pool for administrative costs associated with foreclosure.

There are no such provisions for administrative costs associated with loan modifications. So, even though it is the fiduciary obligation of the servicer to maximize the economic benefit to the pool as a whole, in terms of the reimbursement structure, there is reimbursement for administrative foreclosure costs generally, and not for modification costs.

We recommend, going forward, that pooling and servicing agreements be changed so that servicers can get reimbursed for costs associated with modification as well. But again, I reiterate that our view is that regardless of the reimbursement structure, it is the fiduciary obligation of the servicer to maximize the benefit to the

pool as a whole. And generally that will mean a modified loan will perform better and have more economic value than a foreclosed loan.

But we do think that—as Chairman Frank mentioned—there may be a way to build in some ability to reimburse the servicer's costs for performing loans. But we think that it should be tied to whether the loan actually performs once it is written down. I think Governor Kroszner referred to that type of incentive as well. I think you want to make sure that if you try to enhance economic incentives for servicers, that they are doing real write-downs and giving FHA a loan that will re-perform over the long term.

Ms. WATERS. Have you or anybody taken a look at these administrative costs? One of the problems we have up here is with our regulators. We knew nothing about the no-doc loans. We didn't know the extent to which the ARMs were being offered. We didn't know about these exotic products. And our regulators didn't oversee them. They didn't tell us anything. They didn't warn us. They didn't vet them.

Now we are being told that the servicers are making money on foreclosures. And you are saying no, they are reimbursed only for administrative costs. Are the administrative costs truly administrative costs? Do you know that? Can you represent to us that they are not making a profit on it, that there are simply administrative costs being reimbursed?

Ms. BAIR. Some servicers are parts of large organizations that have affiliate units that do foreclosures. There has been some publicity surrounding that, and there have been issues raised. These are not institutions that we regulate, so I can't really comment.

But there are some servicers that have affiliates that perform foreclosure functions, and—

Ms. WATERS. Who regulates—

Ms. BAIR. I don't talk about specific institutions, but we would be happy to talk with your staff.

Ms. WATERS. Does anyone know who has the responsibility for knowing the question that I am asking about whether or not the servicers are making a profit on foreclosures? Who can give us information on that? Anybody?

Mr. DUGAN. Ms. Waters, it is my understanding that most of the agreements with servicers, and a number of the national banks that we regulate do perform servicing functions, provide for normal servicing costs, which is generally about 50 basis points, plus administrative costs. And it may include some overhead.

But the whole point here is that they do have to be compensated for the services that they are providing.

Ms. WATERS. Yes. I don't mind compensation, if I may.

Mr. DUGAN. Sure.

Ms. WATERS. But I asked a question about whether or not they are making money. The problem that we have here is we don't understand the details and the nuances of all of the servicing. And I simply want to know who understands it, and who knows it, and it seems as if nobody does.

I yield back.

The CHAIRMAN. The gentleman from Illinois, Mr. Manzullo, is next on the list I was given.

Mr. MANZULLO. Thank you. I appreciate your coming here. And Mr. Chairman, I appreciate your putting out a working draft before moving to the exact language on your proposal.

I have some issues dealing with the liens. The draft talks about eliminating existing liens on mortgages—I am sorry, existing liens on the title, and that those would be extinguished when the mortgage is refinanced. At any given time, I am assuming that there could be a typical mechanics lien on the property from somebody who put in new windows and was not paid for it, to a home equity lien, to a property tax lien because of failure to pay real estate taxes.

I am very much interested in how eliminating these liens would be resolved, and if it could be resolved in something like that, which is similar to an 11 cramdown in bankruptcy in a corporate setting, the impact that this would have on the people who possibly gave the liens, such as the home equity lien, or the people who obtained the liens by way of a judgment, or a mechanics lien. Anybody can answer.

Mr. DUGAN. Well, I will start. It is my understanding that it is voluntary for the lienholder.

The CHAIRMAN. If the gentleman would yield, that is correct. It is a voluntary—

Mr. DUGAN. And so what that means is in order to get the second lienholder to participate, I think that there is going to have to be some kind of concession made as a matter of negotiation. The reality is it would probably mean a bigger write-down in the value of the first loan with some negotiated payments to second lienholders.

Mr. MANZULLO. So it is a composition?

Mr. DUGAN. Pardon me?

Mr. MANZULLO. You are talking about a composition.

Mr. DUGAN. Well, it is a voluntary negotiated structure to see what it would take for them to extinguish the—

Mr. MANZULLO. Okay. And that would apply to judgment creditors and property tax liens and mechanics liens, anybody who has a lien on title?

Mr. DUGAN. I am most familiar with the second—the home equity lien. I don't know about the other liens.

The CHAIRMAN. If the gentleman would yield to me?

Mr. MANZULLO. Of course.

The CHAIRMAN. I guess the important question—yes, the assumption at this point is it would be—if anybody had a valid lien, we couldn't extinguish it. We wouldn't try to extinguish it. It would be voluntary. The servicer who was making the overall deal would have the obligation to pay it down. And if it was too much, and it didn't pay, then we wouldn't have a deal. But it would come out of the servicer's—it would be the servicer's obligation, or the borrower's, to make the deal with those people.

Mr. MANZULLO. The second question would be: If you have one of these proposals and there is a write-down on the mortgage because the property has decreased in value, what happens after 5 years if the property increases dramatically in value? Does the taxpayer get stuck because they in effect put this into effect?

Or does the homeowner make out like a bandit because he bought the house at "X" price, the property fell in value dramatically, then he got a mortgage refinancing at a reduced price, and then the property went up in value again. I mean, what happens after 5 years?

Under the first 5 years, there is a sliding scale. But why should the U.S. taxpayer step in, rewrite somebody's mortgage because there is a loss of equity in the property, and then when the person goes to sell the property, there is actually a profit, and the taxpayer gets stuck? Anybody?

Ms. BAIR. I don't want to speak for Chairman Frank, but my understanding of the rationale behind it was to give the borrower an incentive to stay in the house and keep making mortgage payments. I don't think any aspect of this situation is fair, frankly. I think, as has been pointed out, most people do make their mortgage payments on time. We just have a very difficult situation.

Now we have a situation where we have a lot of unaffordable mortgages out there, and because they are going underwater, there are more and more loan defaults. We are moving from an ability to pay to a willingness to pay situation.

So I think even though this bill focuses on affordability, it recognizes that negative equity can impact the borrower's willingness to stick with a mortgage.

The CHAIRMAN. If the gentleman would yield to me?

Mr. MANZULLO. Yes.

The CHAIRMAN. I think I can address that. It is a very good point. There is no magic to the 5 years, and that would be one of the issues that—

Mr. MANZULLO. Well, my issue would be, for me to go along with something as dramatic like this, if you want a handout from the taxpayer, then be prepared to hand it back when you sell the property at a profit.

The CHAIRMAN. I was trying to agree with the gentleman.

Mr. MANZULLO. That is what really bothers me about this legislation, Mr. Chairman, is—

The CHAIRMAN. I was trying—if the gentleman would yield, I have been trying to agree with that point. But I will withdraw that effort if he doesn't want to be agreed with.

Mr. MANZULLO. Thank you.

The CHAIRMAN. What I am saying is that there is no magic to the 5 years. And yes, that is open for discussion, but I don't want to say that it is not fair to put it on them because—

Mr. MANZULLO. No. I just want to make another comment is, you know, anybody who has bought a brand-new automobile at 100 percent financing, the very next day it drops 20 percent in value. So, I mean, what is wrong about making payments on an item when your lien is more than the value of the property? It is done on $25- and $30,000 automobiles. And what is wrong with doing that on a house? Because the house eventually will appreciate in value. Just a point, Mr. Chairman. Anybody want to handle that one?

Mr. DUGAN. Well, I guess I was going to say that there is nothing wrong with that. I think the assumption is if a borrower can afford to make the payments, they should continue making the payments.

It is only when they can't afford to make the payments, and are in threat of foreclosure, that they shouldn't.

But one of the concerns expressed by servicers, and I know you will have a chance to ask them that question, is it may give an incentive for people who can afford to pay not to do so in the hope of getting a written-down mortgage at a lower amount. That is one of the issues.

Mr. MANZULLO. Thank you.

Ms. BAIR. I would also say that the write-down is designed to protect the government, because if FHA is refinancing these loans, you are building an extra cushion in case there is a default. There is a much better chance that, if FHA has to go into a foreclosure, they are going to recoup their costs.

So building in that cushion protects the government, even though you are right—if the loan continues to perform, then under this bill, the borrower will be able to capture that appreciation if they remain current on their loan. But if they stay current on their loan, there will be no cost to the government. The loan will perform and FHA will not have a credit loss.

Mr. MANZULLO. Thank you.

The CHAIRMAN. The gentlewoman from New York.

Mrs. MALONEY. Thank you very much.

In order to forestall a meltdown of the financial sector, the Fed recently employed some creative, unprecedented, and I would say controversial steps to ease the credit crunch. But the Fed does not have a tool to address the real problem, the decline in home prices that is causing the banks to have a need to readjust their balance sheets and build up capital. And therefore, we have this proposal that Chairman Frank and the Democrats have put forward.

I would like to thank Chairwoman Bair and Governor Kroszner for your supportive comments of our efforts. And I would like both of you to comment further on the legislation on the very important need that, Chairwoman Bair, you pointed out in your testimony, that we need to encourage incentives for lenders and servicers to buy in and to support this program.

What other steps need to be taken? Obviously, if there is a foreclosure, there is a loss to all concerned. And what does the future hold for us. Is this going to work, or will the economy continue to decline? Will this stabilize the economy? Your comments, please, Chairwoman Bair and Governor Kroszner, and then anyone else who would like to comment.

Ms. BAIR. I think this is an important additional tool, an important initiative. I think Chairman Frank has tried to very thoughtfully structure it to build in the right incentives for investors and servicers and borrowers, and protect the government.

It is one tool. I think we need a combination of strategies. But, I think this is a very thoughtful proposal. We have some additional suggestions. The trick will be to convince investors who frankly, at this point, have not been showing an eagerness to realize losses on these loans.

And so the question will be whether they are willing to go ahead, take the principal write-down, realize the loss, and enable the loan to be refinanced out of the pool. The benefit to them, of course, is that then the credit risk is gone.

Finding that magic number, finding those right incentives, I think, is very challenging. But this is a very, very thoughtful approach, and I think it will be a very important tool. I think perhaps it needs some further fine-tuning, which is why he has proposed it as a discussion draft. I think it will be a very important tool, but, we do need a combination of strategies. This could be very, very important.

You know, FHA traditionally did this. Traditionally, they were the guarantor of low- and moderate-income loans with their nice, stodgy 30-year fixed mortgages, which we all fondly remember now. I think bringing some of this market share back to FHA makes sense. If there is a policy reason for government providing support in the mortgage area, it is probably the strongest with an entity like FHA and its role of supporting low- and moderate-income housing.

Mrs. MALONEY. Governor Kroszner?

Mr. KROSZNER. Thank you. Yes, I think it is important to remember that the Fed does have limited tools. Some people think that we have every tool available, but there are many tools that we don't have. I think it is important to be considering other actions, and that is why we have been working very closely with the committee on thinking about alternatives.

The incentive issue is really the key issue, and I am really glad that you focused on that, because in my testimony I emphasize the role of moral hazard, of people taking advantage of a program like this. And that would be for the borrowers trying to get into this program inappropriately, or for servicers putting bad loans into the program.

These issues have come up, and I think the bill tries to address some of these concerns through exit fees. This also addresses an earlier question that, my understanding is from the draft legislation, that anyone who got into this, a borrower who got into this program, whenever they would leave the home or refinance, would have to pay an exit fee of 3 percent, even if that were beyond the 5-year horizon. So there would be some sort of fee that would be collected by the government.

There is some risk-sharing that goes on up to 5 years, and obviously that could be—there is no particular magic about those 5 years.

With respect to adverse selection of putting bad loans onto the taxpayers' books, it is very important, as a number of us have emphasized, to make sure that the risk premium that is charged, the insurance premium that is charged, is risk-based. And so that is one important way to protect the taxpayer, and clarifying that in the bill would be valuable.

But there could be other things, things that are standard parts of loan servicing contracts, that if something were to go wrong with a loan within a specified period of time, they would be able to put the loan back into the servicer. So they couldn't just get away with putting bad loans back on.

Given the challenges and the turmoil in the financial market, I think it is important for Congress to be considering alternative options.

Mrs. MALONEY. Thank you. My time has expired.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. Undoubtedly, we on this committee and in the entire Congress have some very important policy decisions to make. And as we make these decisions, it is always nice to make sure that we also know the facts.

I would like to review the facts as I know them, and see if anybody on the panel has substantial disagreement. As I understand it, if we took a snapshot today, we still—we have roughly 5 percent of mortgage borrowers who are delinquent, roughly 2 percent who are in the process of foreclosure. Is that a fairly accurate snapshot of where we are today? I don't see any dissent.

I also understand that we have roughly—of 108 million occupied housing units in America, roughly 25 million have paid off their mortgage, and roughly 33 million are renters, which means the universe of those with mortgages is less than half of the families in America. Is that a fairly good ballpark figures for the numbers? I see a lot heads nodding in assent.

One question I have, clearly I am troubled by certain moral hazard aspects of various policy solutions that I have seen put before me. I am curious if any of you on the panel are familiar with this report from FinCEN, the Financial Crimes Enforcement Network, entitled, "Mortgage Loan Fraud." It is a fairly recent report. Is anybody familiar with the report from FinCEN? I know you are all acquainted with FinCEN. No one has read this specific report?

Mr. DUGAN. I am familiar with it. I have seen the press reports, but I have not read the report itself.

Mr. HENSARLING. Well, I reviewed this report last evening. And when we are looking at the different people who may be assisted under various legislative proposals—and I am unfamiliar with who might have greater credibility on the subject of these activities; I am sure there are folks at HUD who would be well acquainted as well—but according to a FinCEN analysis, as I read it, fraud is up over 1,000 percent. Mortgage fraud is up over 1,000 percent in the last 4 years, with over half of it being attributable to misrepresentation of income, assets, debts, and occupancy fraud, with a fair amount, 28 percent, attributable to forged and fraudulent documents.

At almost every hearing we have in this committee room, we hear the phrase "predatory lending." But I am curious whether this might suggest that a fair amount of "predatory borrowing" has taken place, and that there are many borrowers who do not have clean hands who still might benefit substantially under a bill that we are considering now.

Is anybody troubled by the moral hazard aspect of that and how that could affect future behavior? Does anybody care to offer an opinion on the subject?

Mr. DUGAN. We have seen a very sharp rise in mortgage fraud from a variety of different directions, not just from the borrowers, as you suggested, but from the purveyors of the products as well. I do think it's quite important that the bill have standards in it to screen out people who have not only had fraud in the past, but can't find their way into an FHA loan that they can't afford to repay, and I think that is what the standards are intended to do by the underwriting strictures that are in it.

But I think, going forward, the whole notion of having to document income, which is I think a critical feature of this bill and certain of the guidance that had been put out by the Federal banking agencies, is part of that process and is absolutely critical.

Mr. HENSARLING. Although I don't have a copy of it, I was also reviewing a Fed study from the Boston Fed that I think is maybe a month or two old, dealing with the reason for subprime defaults. And in that particular report, it seems to make the point that it's not so much the reset that is causing the default; it is the devaluation or diminution of the value of the asset, which would seemingly suggest that a number of people entered into these financial transactions, never intending on being able to pay the reset, but they were banking on the appreciation of the asset.

Mr. Kroszner, I suppose you may be familiar with this study, and if so, is that a proper take-away?

Mr. KROSZNER. Yes. I think that study really tried to look very carefully at the role of resets versus the role of the asset prices, and I think what the study suggested is that at least through 2007, the resets were not the key to driving the increase in the delinquencies and the foreclosures, but really these were early payment defaults, in many cases within just a few months of initially taking out the loan. That suggests that it's not the reset, which comes 2 to 3 years later, but the value of the property or the reduction in the value of the property that is driving the consumer behavior here.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman.

Let me direct a couple questions to Mr. Montgomery and Mr. Kroszner. First of all, Mr. Montgomery, I'm having a little trouble understanding your response to an earlier question from the chairman that this program would have the effect of exposing taxpayers to greater risk. As I understand it, this is an FHA-insured program, which has increased flexibility to set rates by FHA, and then subsequently has the potential that FHA can share in the sale appreciation value if there is sale appreciation value. I don't understand how we get under those circumstances to increased risk for taxpayers over what FHA currently has in place.

Mr. MONTGOMERY. FHA is a self-sustaining entity and we want to remain that way, so by pricing our premiums based on risk from an actuarial standpoint, these new modifications we want to make will allow us to remain a self-sustaining entity.

In our proposal, there would be no profit at the end of it, so to speak.

Mr. WATT. No, I am not talking about your proposal. I am talking about the proposal contained in the chairman's bill. I don't understand your earlier response that this bill increases taxpayer risk.

Mr. MONTGOMERY. Oh, I'm sorry if you heard that. I didn't say that. I said that the chairman's premium structure contains risk within that structure. We do the same.

Mr. WATT. Okay. That's fine. If I misunderstood what you said, I just misunderstood what you said. I thought you said that this program would increase the risk to taxpayer—

The CHAIRMAN. Would the gentleman yield briefly?

Mr. WATT. I am happy to yield.

The CHAIRMAN. I caused the confusion, so let me clarify it. There was some criticism aimed at the bill we had, and my point was that it would be aimed at the Administration—namely, that if we greatly underestimated the default rate, it would break through the barrier of the premiums, and that is where the taxpayer would be exposed, because the taxpayer is the backup to the FHA. And I was simply trying to make the point that would be a common factor of both.

Mr. WATT. Okay. That helps me because—but that's the risk that we have now, I suppose, through the regular FHA process.

Mr. MONTGOMERY. That is correct.

Mr. WATT. Okay. To the extent that insurance premiums have to go up or GSE is being encouraged under various programs—GSEs are being encouraged to either take greater risks or help build some of these properties out, one of the concerns always is that we are increasing risk to other entities that are designed to shield the government against risk or shield taxpayers against additional risk.

I'm looking at a 1999 report called, "Over-The-Counter Derivatives Markets, A Report of the President's Working Group on Financial Markets." There were a series of suggestions made back in 1999 about how to shield GSEs, FHA, and anybody who is doing swaps and derivatives against greater exposure. One of those was to encourage a clearing process that allowed those swaps and derivatives to be put on a platform just like stocks. What is happening with that, Mr. Kroszner? Are we making any progress on that currently?

Mr. KROSZNER. These are very important issues, and I'm very glad that you raised them, because this is often what is characterized as the plumbing of the system, sort of the background that people don't see, but is crucial to the functioning of the system.

And actually, in all of the credit market turmoil that we have seen, we so far haven't seen a problem with the clearance and settlement of these types of contracts. I think part of that is because there has been an initiative in the Federal Reserve System headed by the New York Fed that tried to address some of these issues, making sure that the clearing and settlement process is well-functioning, to make sure that trades are settled rapidly, to know who the responsible person is if that trade needs to go through quickly.

There is still a large growth of over-the-counter derivatives, but there is still a very robust market of things that are on exchanges, a healthy competition between the two. But we have been working tirelessly to try to make sure that background plumbing in the over-the-counter market works as smoothly as it can. And so we have been heartened, at least so far, that the credit market turmoil hasn't turned up problems there, but we still need to do more work.

Mr. WATT. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. The gentleman from California, Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman. I think three out of five of you mentioned adverse selection as a potential problem with this, and several of you mentioned proposed ways to mitigate that. And I guess my question, which is for the entire panel, is that no

matter what you do in terms of mitigation, doesn't someone holding this loan, Merrill, CitiBank, UBS, WAMU, or now Blackstone, TPG, or whomever, sit here and say, if it's voluntary and loan-by-loan, they say, "All right, we have this loan, and the FHA will pay us 'X.' If we think we're going to get less than 'X,' give it to you. If we think we're going to get more than 'X,' keep it." So that no matter what mitigation you do, you will have adverse selection; you must reduce the amount of it, based on what the money center banks believe the loan is worth. And I am asking any of you that.

Mr. MONTGOMERY. I would just say that in the case of FHA, one corner that we will never cut is our underwriting criteria. By the way, we currently have an adverse selection within FHA to the point I referenced earlier on the seller-funded downpayment assistance. By mitigating that risk, by pricing that risk accordingly with the premiums, we can mitigate going further and helping more subprime borrowers refinance through FHA.

I want to be very clear that not everyone is going to be able to qualify because of our very rigid front-end and our very rigid back-end ratios. So we think we can mitigate a lot of that going forward.

Mr. CAMPBELL. Under the chairman's proposal? The President's proposal? Or both?

Mr. MONTGOMERY. Well, certainly under our proposal we—and I won't speak for the chairman—he has some form of risk-based pricing that goes even higher than us, so I'm assuming he's probably going to get at the same issue.

Mr. CAMPBELL. Yes, Governor?

Mr. KROSZNER. Yes, on this issue, adverse selection is extremely important, and it is a problem that is never fully solved even in private insurance contracts, because there is always the case if you were buying insurance, you're going to the insurance company, you may know a little bit more about yourself than the insurance company does. They may ask you a lot of questions, but they can't ask every possible question. And so, who is most likely to buy any type of insurance at a current rate? Well, the person who finds it most valuable for themselves.

That is why insurance companies in the private sector charge risk-based premiuns; they use a variety of other criteria to try to screen out people who are just trying to put bad activities to them. And that is why something like what I have proposed here, if you were to go down this path, to make sure that there is an ability to put back a loan that goes badly quickly. Because if it goes badly within just a few months, that suggests that the servicer knew something about that loan that was very difficult for the FHA to find out, and so to have that option to put that back would be valuable.

That's a standard part of private-sector service contracts, to try to mitigate exactly this moral hazard problem. It's not perfect, but it's an attempt to address it.

Mr. CAMPBELL. Anybody else with to comment? Yes, Chairman Bair?

Ms. BAIR. Yes. I would just note that I think it's an inherent issue, and it is with any kind of government program along these lines. We think it is important to have strong DTI standards—underwriting standards—as part of this, while recognizing that you

want to be flexible to reach out to a broad range of borrowers. Also, put-back provisions are a common private-sector tool. In addition, holding some portion of loan proceeds back and releasing them later if the loan continues to perform is another way you can try to address this problem.

Mr. CAMPBELL. Okay. My second and final question is related to what I mentioned earlier in my opening statement about Citibank's apparent sale of $12 million of leverage loans off to private equity. I am aware of some other smaller transactions going on where there appears to be a market developing out there now where there appear to be buyers, and I have heard 50 cents on the dollar. I don't know what the numbers are, but there appear to be buyers for loan portfolios that are out there now.

If this is developing, and this is going on, first, do we really need to do what is being proposed here? Or does this mean the private market is going to deal with it? And second, if you are Blackstone or TPG, and you buy this thing for 50 cents on the dollar, and along comes an FHA guarantee that enables you to get 60 or 65 cents—and you know, maybe these numbers are wrong—but 60 cents on the dollar, then aren't we really providing an exit strategy for this secondary or tertiary, if you will, market?

Mr. MONTGOMERY. I have heard some of the same—and this is Title II of the chairman's bill—but we would just submit that FHA is not there to do these wholesale auctions of loans. I do want to say that obviously you do bring up one, some have called another moral hazard, but I want to say from our perspective, from the Federal Housing Administration, we just want to do what we can to keep that family in the home, and by putting these parameters around it, yes, some may benefit as you have described, but we think going forward, the important thing is that we help mitigate the ripple effect, but more importantly give the family a lifeline to stay in their home.

Mr. CAMPBELL. Governor Kroszner, do you have any comment? Or anybody else?

Mr. KROSZNER. Yes. I think it is very important to make sure that the taxpayer would be protected in any program that goes forward to take care of the moral hazard and adverse selection problems, so that the risk premia that the FHA can charge would accurately reflect risk on average. They may get individual ones wrong, but it's trying to get right on average, trying to deal with the moral hazard problem. That is extremely important.

The CHAIRMAN. The gentleman's time has expired. Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman. Gentleman, I'm having a hard time following some of this, and I just want to ask some questions particularly relative to the moral hazard, and some of the concerns that I have heard mentioned. I want to be specific, if I can. The moral hazard you are concerned with is it somehow rewarding people who engaged in bad behavior, or is it being concerned about making sure that no one else engages in similar bad behavior in the future? Or is there something else?

Mr. KROSZNER. Well, in particular, what I had been focusing on with respect to the draft legislation is that you would get people to come into this program who otherwise aren't in trouble and who

don't need a program like this. And so that is why having standards about the high—

Mr. CAPUANO. So you are concerned about helping people who don't need the help?

Mr. KROSZNER. Yes, exactly.

Mr. CAPUANO. Okay. And Mr. Montgomery, is that the same for you? Your concerns are that we are concerned about helping people who may not need the help?

Mr. MONTGOMERY. Yes. I would share in that concern. Ours is focused more at those who have missed payments and those who are now also underwater in their loan as well.

Mr. CAPUANO. All right. So neither one of you are opposed to the concept of helping people. If we could all come up with a clear definition of who is deserving of help, or who is in deep trouble, would you be opposed to helping them a well?

Mr. MONTGOMERY. Certainly that's something we can discuss going forward. You know, again, ours is a measured response that is targeted at those—

Mr. CAPUANO. I understand that. But you wouldn't be opposed to the concept of helping somebody?

Mr. MONTGOMERY. We can certainly discuss any options you would ask, Congressman.

Mr. CAPUANO. Mr. Kroszner, would the Fed be opposed?

Mr. KROSZNER. As I said in my testimony, I think we need to think of creative ways to try to deal with preventable foreclosures, and so if there's a way to get the servicers to come up with good standards, to be more proactive in doing principal write-downs and other modifications, these are one of the many types—

Mr. CAPUANO. So you're saying that if we get into helping somebody, we should then hold the industry to some sort of standards and requirements going forward?

Mr. KROSZNER. Well, I think one of the things that the industry has started already with the Treasury Department is the HOPE NOW Project focusing on resets, but in response to the earlier question—

Mr. CAPUANO. No, no. I want you to respond to my question. Are you saying that if we get involved right now, we should hold people that we are going to help to certain standards, going forward?

Mr. KROSZNER. Absolutely.

Mr. CAPUANO. All right. So then, I don't disagree with the general concept, but if that is the case for individual homeowners who are losing their homes, could you explain to me, then, why as we speak, right now, right this minute, the Fed is loaning money, billions of dollars, to people who are held to no standards, who are not regulated by anybody at this table or anybody else, and we don't even know whether they meet any capital requirements? Could you explain to me why we're doing that?

If it's so important on the individual homeowner to hold them to certain financial standards, why are we not holding investment banks and hedge funds and others to those same standards as we are loaning them billions of dollars? Not we might, we are. Right now, right this very minute we are doing it.

Mr. KROSZNER. With respect to the lending facility to the primary dealers and lending supporting the Bear Stearns transaction,

Congress has given us the power in unusual and exigent circumstances to make exactly such loans.

Mr. CAPUANO. Well, that's not responsive. First of all, I'm not so sure we have, which is a discussion for a different day. If it's okay—and I don't disagree with you—I absolutely agree with the concept, if we're going to do something extraordinary that we should ask those that we are helping, both the borrowers and the lenders, to be held to certain standards—I have no problem with that, yet for some reason it's okay for homeowners, but it doesn't apply to investment banks. And I'm just curious as to why that is.

Mr. KROSZNER. Well, I don't think that's true. The—

Mr. CAPUANO. So you're telling me that right now the Fed is holding people who are coming to the discount window that you do not regulate, that you're holding them to different standards than you held them to yesterday?

Mr. KROSZNER. You had suggested that there was no regulation of the investment banks. There is regulation of the investment banks.

Mr. CAPUANO. Virtually none. I should have been more clear. Virtually none.

Mr. KROSZNER. The SEC does have a number of standards out there. They are the regulator of those institutions.

Mr. CAPUANO. Yes. I know who regulates them. I know what a great job they have done thus far, which is exactly why you had to come in to save Bear Stearns. Now, I don't have any problem with saving Bear Stearns, and I would argue that maybe the law allows that; but I have some concerns about the Fed opening the discount window for 60 days, and not a single person here has said anything about it. We're all concerned about maybe taking a risky loan from some working stiff who is about to lose their home, but we're not concerned at all, we don't seem to be concerned one bit about making loans in the billions of dollars to people who actually participated and encouraged and made the profits, the billions of dollars of profits on those very same risky loans.

And that's what bothers me. We have several standards, one for the typical homeowner—let's hold them to a higher standard—and another standard, which for all intents and purposes doesn't exist, to investment banks and others who engage in the very same risky behavior that you and the rest of the regulators did nothing about for the last 6 years. My time has expired.

The CHAIRMAN. The gentleman's time has expired.

Mr. Marchant, you are next on the list.

Mr. MARCHANT. Thank you, Mr. Chairman. My question is for HUD, Mr. Montgomery. Mr. Montgomery, in my time on this committee and in watching all the programs, HOPE NOW, and all of these programs that come out, it seems that the major problem comes in the implementation stage, and I'm trying to get a handle on who would be the person in Mr. Frank's draft bill, what party will instigate the request for the loan to be reappraised, bought, and then recast?

Mr. MONTGOMERY. I don't want to speak for the chairman, but I could say for FHA's part, what is happening now with people who are looking to refinance, either they contact us, or they contact a lender or a servicer. It all depends on the borrower's behavior. You

know, a lot of borrowers who are in dire straits never contact anyone. So for our part, it could be any number of parties who would initiate it.

Mr. MARCHANT. So it couldn't solely be the servicer? The servicer could not come forward and say I have this loan, this loan is in trouble. I would be willing to put this loan into this program and will HUD buy the loan from me?

Mr. MONTGOMERY. As is the case now, there's a current mortgage or obviously they have to agree to some sort of refinancing mechanism, and any subsequent other lienholders as well.

Mr. MARCHANT. So in this bill, how much does the homeowner have to say about the actual refinancing? Because if you have, let's say you have 2 million loans that are rolling over in the next 6 months, and let's say that there's a reasonable expectation that for a good number of those, the interest rate will put the borrower into a situation where they may have to default. Will it be the borrower who will step forward and say, "I would like to take advantage of the provisions of the Frank bill?" Or will it be the servicer who steps forward and says, "I would like to take advantage of the provisions of the Frank bill?"

Mr. MONTGOMERY. I can't speak to what the chairman's bill does in that respect. I would say that as is the current practice, in most cases it is the mortgagor who is in the subprime loan, or whatever loan right now, who wants to refinance with FHA, and does so through their lender, who then works—it has to be an FHA-approved lender, obviously, who then starts the process there.

So certainly a servicer, as we have discussed, has a say in that process as well, especially to the degree that we want to do a write-down of that principal, again whether it's a first lien or second lien.

Mr. MARCHANT. So what is the practicality of $300 billion worth of loans being—either the servicer or the borrower coming forward and saying, "We want to rework this loan; we need to go get an appraisal; we need to get title work; we need to knock out the seconds, and we need to re-originate this loan with sophisticated loan documents that carry a silent second," and you know, what is the practicality of getting those loans? Are they going to come one by one? Are they going to come in big bundles? Is the servicer going to have the ability to advertise on TV that, you know, if you qualify for this program, come in, and then they are going to bundle them up and send them to you like in a Ginnie Mae commitment? What are the mechanics of how HUD will end up with those—will they be Ginnie Mae instruments eventually?

Mr. MONTGOMERY. Well, for our part, they would certainly be, you know, backed by the full faith in credit. They would be Ginnie Mae's. You know, one or two, whatever particular pool.

But you did bring up the issue of the $300 billion, and again I don't want to speak for the chairman's bill, but that is a loan allocation amount. Congress gives this amount every year. Since I have been FHA Commissioner, that number has been about $185 billion. I do want to say going forward that we expect for the first time in several years to exceed that amount for this fiscal year. I think ultimately we'll probably get to about $230 to $235 billion.

So I don't know, again under his bill whether he has a separate allocation just of $300 billion, or it raises our allocation to $300 bil-

lion. To put the number in perspective, our overall insurance in force today is roughly 4 million homes with a value of a little more than $400 billion, to put that $300 billion—

Mr. MARCHANT. But do you foresee—

The CHAIRMAN. The gentleman's time has expired. I was trying to allow the response, but are you all through responding?

Mr. MONTGOMERY. I could certainly follow up with the Congressman afterward, if he'd like.

The CHAIRMAN. The gentlelady from New York, Ms. McCarthy.

Mrs. MCCARTHY OF NEW YORK. One of the questions that I'm concerned with is, because obviously all of us care about our constituents back at home—and this can go to everybody—is how will this bill assist homeowners in high-cost areas, such as where I live on Long Island? So even though I have a small part of it, I'm going to look at Long Island as a whole, because what affects a district right next door to me is going to affect my district and so forth.

Right now, we see almost a 33 percent increase of foreclosures just in Nassau County. My concern is too because I tend to look at things out, with 33 percent foreclosures, that is going to hurt the tax base in the county and in the towns, and that is going to reflect again on police service, school service, and everything else like that.

So for a high-cost area, you know, I will use my little home as an example—I have been in it for 58 years, it is a tiny home, and I am assessed for an amount that I know I could never sell it for—I think they had me assessed for maybe $885,000—it is now down to, I think, $468,000. But I'm still being assessed on the higher level. I am going to fight that, but that means it is going to come down.

But how is this going to help someone to buy a home in Nassau County, even a starter home? The cheapest you are going to find as long as it has, you know, doors and a frame—is probably almost $350,000, but most of them are much higher—how will this help them and how are we going to stop the bleeding that is going on? If one house goes down, that lowers the whole neighborhood. That's the problem that I think this Nation is going to be seeing, not just the losing of one home, but how it's going to affect the neighborhood, how it's going to affect the community, the stores, the tax bases, and everything.

I don't hear a lot of people talking about that kind of stuff.

Ms. BAIR. Well, I think there are a lot of external costs to foreclosures—to neighborhoods, to communities and to local tax bases. And I think that is exactly the public policy rationale for moving forward with a proposal like this.

I think this proposal, in particular, is focused on those who are currently in unaffordable mortgages and cannot refinance because their loans are underwater. They would be subject, I assume, to the FHA conforming loan limits. So in very high-cost areas, it may or may not be relevant.

A lot of the foreclosure activity is being driven by subprime loans, particularly the subprime hybrid ARMs. On a national basis, the average subprime loan is $200,000. So, I think for this particular proposal, the impact would be more in that sector—again

people who have unaffordable loans and who are underwater and can't refinance out of these unaffordable loans.

I don't know, Brian, if you want to—

Mr. MONTGOMERY. Yes. Congresswoman, your Nassau County, Suffolk County are both in the—they are 2 of the 75 counties in the United States that went to the maximum ceiling for FHA and the GSEs as a result of the stimulus. So up to $729,000, they would now be eligible to apply.

Mrs. MCCARTHY OF NEW YORK. Thank you.

The CHAIRMAN. Does the gentlelady yield back?

Mrs. MCCARTHY OF NEW YORK. I'm sorry, yes. I turned my microphone off before. Yes.

The CHAIRMAN. Okay. Then the gentleman from California, Mr. Miller, for 5 minutes.

Mr. MILLER OF CALIFORNIA. Thank you very much, Mr. Chairman.

A lot of the problems we have in the marketplace with people trying to buy today is that they can't get a loan. There is no liquidity. And I have always strongly supported raising conforming in high-cost areas for Freddie Mae, Fannie Mac, and FHA. I think that is really something we need to do.

But I have some questions based on some different testimony. Mr. Montgomery—and you were very clear in what you said, you were talking about when FHA makes a loan of 90 percent based on market value—that's generally a very safe loan, because you use the standard underwriting criteria and you use risk-based criteria as it applies to loans. Is that not true? Would you consider a 90 percent loan using your standard criteria and the criteria applied to this bill? Would that be a reasonable loan for FHA to make?

Mr. MONTGOMERY. Yes. Certainly. We propose 90 percent LTV. I believe the chairman has an 85 percent LTV—

Mr. MILLER OF CALIFORNIA. But the concept is the same. You—95 percent would be held in retention, but—my concern that Governor Kroszner, you have stated in your testimony that you believe that there should be some form of a loan seasoning requirement or other form of warranties on the part of the lender, who currently has the loan that is probably going into default because the person can't make the payment based on a trigger or whatever.

And I have a real problem with that, because my concern is that you are then placing an obligation on the previous lender to guarantee FHA that there would be a repayment, and I'm sure there is some risk associated with that, and if the lender is trying to cut a deal where he says, "Okay, I'll take 85 percent," what is the bank regulator going to do? There has to be a risk. Is he going to require some sort of reserves on the lender, who thinks they're getting out from underneath the loan, but they possibly might not be getting out from underneath from the loan.

That's problematic. I don't know how we do that. Maybe you can explain that a little more.

Mr. KROSZNER. Sure. I mean one of the reasons for doing this is that we don't want the taxpayer to just take all of the very high-risk—

Mr. MILLER OF CALIFORNIA. Yes, but the FHA is not going to let that happen. FHA is using a risk-based criteria. FHA—Mr. Mont-

gomery, you're going to go make sure the person has an income, they have the ability to repay that loan, and the loan is based on sound underwriting criteria and an appraiser that reflects what the value of the home is. Is that not true, Mr. Montgomery?

Mr. MONTGOMERY. Yes, sir.

Mr. MILLER OF CALIFORNIA. Then, my position is that the lender should be out of this loan at that point in time; he should not have to be obligated to FHA, if FHA has done their job and done proper appraisals and used underwriting criteria. If the person is not qualified, FHA should not make them the loan. So I'm having a real problem with the concept of taking a previous lender and leaving them on the hook in some fashion if something goes wrong because we are basically charging a 5 percent reserve on the loan—because we're lending 90, we're reserving 5 back because we're only paying 85 percent of what the value is—I think the lender should be out of this.

So, Mr. Chairman, I have real, real concerns with leaving a lender on the hook when FHA has done a proper job on their appraisal standards and they have come up with a loan that is qualified. Because if it's not qualified, Mr. Montgomery, don't make the loan. And I think you're saying we're not going to. So I have a real problem with leaving the lender on the hook, because there's going to be some reserve set aside on the lender's part, and lenders today are having problems with liquidity, with money in the system. So I think we need to really look at that.

I think there are some reasons why this could be a very popular program with lenders, more than most people might assume. If you figure what the lenders' costs are when they go through a foreclosure, the cost of foreclosure, they're going to generally employ a Realtor to handle the transaction; they're going to have to set up reserves and the costs of carry associated with that loan when it's not producing; title and escrow fees that are going to be normal to any transaction on any foreclosures they have; damage that occurs to the unit, and in some cases people do vandalize units because they're angry because they got evicted from a home—not everybody but some people do it, and we have seen that happen.

Some even have to go to the cost of using an auction to unload a unit because it sit on the books too long and it's not moving. And then there's a maintenance cost and a risk associated with holding that house.

So some lenders are going to say 85 percent? Hmm, I'll take 85 percent. And I think you're going to see more people looking to do that than not.

I guess I have a concern that we're talking about how we're going to deal with eliminating or extinguishing a second trust deed that might exist on a home. The concern I have is that some people have used their home as an ATM; they borrowed for vacations and other costs. I think we need to look at what some of those seconds are, if we're asking some lender to take a bath on it and not really do much to encourage it when it has been used for personal reasons.

A question I have is: If we implement a program like this where we say the lender is going to taking 85 percent of market value, my concern is: Is there some undisclosed occurrence that could hap-

pen where an appraiser down the road says, "Well, the house really is only worth—if it was $500,000 before if the lender took $425,000, really the market value is—"

The CHAIRMAN. We will have to wrap that up so they can answer, please.

Mr. MILLER OF CALIFORNIA. Okay. Could it somehow impact the market, you saying it's no longer worth $500000, it's really worth $425,000, because the lender took $425,000 for that?

Mr. MONTGOMERY. Well, in this case, whatever that delta is between the appraised value and our 90 percent insurance could be put in the form of a soft second with a note due on sale clause.

Mr. MILLER OF CALIFORNIA. Does it impact the value of the marketplace?

Mr. MONTGOMERY. No, sir. That second lien would have to be resolved to—

Mr. MILLER OF CALIFORNIA. Too many questions, and so little time. Mr. Chairman, thank you.

The CHAIRMAN. Let me, before turning the gentleman from Pennsylvania, ask unanimous consent to put in the record a letter we received from the National Association of Realtors saying with regard to the discussion draft, "Your measure will allow homebuyers to refinance their mortgage with an FHA loan at a rate and level they can afford to pay. We commend your efforts." And also, a letter from Marc Morial on behalf of the National Urban League, also expressing support for the discussion draft.

I ask unanimous consent to put these items in the record. Without objection, they will be, and the gentleman from Pennsylvania is recognized for 5 minutes.

Mr. KANJORSKI. Thank you, Mr. Chairman. I am not sure to whom on the panel I should direct this question. Anybody can take it. But, it seems to me for the chairman's proposal to be successful, there are two major elements that are required to be adopted in the law: One would be encouraging a loan modification. We have to do something about getting a servicer's liability worked out to create a safe harbor. And of course, we have, Mr. Castle and myself have proposed a bill to accomplish that. Would you agree as a panel that it is essential that we have a loan modification safe harbor in place if we are to implement the chairman's bill here on servicing?

Ms. BAIR. We are very supportive of your and Congressman Castle's efforts, and yes, the servicer will have to write down the principal amount. They will have to modify these loans to facilitate them being refinanced out of the pool. So at a minimum, I would assume you would want to have some insulation from liability for that and also for other long-term sustainable loan modifications, even when the loan stays in the pool. So yes, we're highly supportive of that.

Mr. KANJORSKI. All right. Yes?

Mr. DUGAN. We support it as well, Mr. Kanjorski, because as you know, we have done some work on our staff. We think it clarifies what is the legal authority already that you have to support, and protects the interests of the whole pool and not an individual tranche or investor within that pool. We do think that is quite an important principle, going forward.

Mr. KANJORSKI. Thank you.

The other major area I throw out, which is now pending over in the Senate and which we passed in the House, is independent appraisals. Everywhere I look, one of the major failures in subprime lending is the abuse, fraud, and mistake of not having appropriate, independent appraisals. If we go through this process again and do not have the proper appraisals, all we are going to do is compound the problem.

Is there anybody who disagrees that the now pending amendment in the Senate—I think it is the Casey amendment, which incorporates a lot of the issues that we have passed in the House—should go through?

Mr. DUGAN. Mr. Kanjorski, we don't agree with this point. We do think you have to have independence and structures within organizations to make sure that there is independence between the person who underwrites the loan and the person who appraises it. But there are circumstances in which you can have better appraisers and be able to control the risk better by having it within your organization than get it from a third party. I don't think it is necessary or that it is even a good idea to mandate that every single appraisal be separate from the entire lending organization.

Mr. REICH. At the Office of Thrift Supervision, I agree 100 percent with the comments that Comptroller Dugan just made. There are excellent appraisals being made within many institutions that we supervise and we believe that they ought to be able to continue to be able to utilize those facilities.

Mr. KANJORSKI. I think there may be a little confusion between what we do in our bill and the attorney general of New York's agreement. I understand your disagreement with some of the stringent positions that he has adopted, but our bill is quite different. Do you see that distinction? Or should we take that up later?

Mr. DUGAN. We will take that up later.

Mr. KANJORSKI. Okay. Good.

Let me ask one question of the Federal Reserve. I just had a very upsetting meeting in my office with a hedge fund operator who called to my attention the fact that that some people may be using the Federal Reserve Bank, some folks in the investment banking industry, to draw down billions of dollars in funds, and then turning around and issuing dividends based on the use of those funds.

Do you know, Governor, whether that is true? What does the Federal Reserve intend to do, as quickly as possible, to put some constraints on the use of these funds? Tell me whether or not you need legislative authority to do so? Do we have some pieces of legislation suggested by the Federal Reserve to get control?

I, myself, will be incensed if after going to the rescue of these institutions, there are these types of abuses occurring. I will be particularly incensed if the Federal Reserve has not marched up here with an emergency siren, saying there is something happening that should not happen, and it is to the great jeopardy of the American taxpayer. Can we get a response?

Mr. KROSZNER. Those are very important questions. I think that I do not know of such circumstances, but certainly will be delighted to work with you and your staff to see if there are such circumstances. I agree that they should not be tolerated. We are

working very closely with Securities and Exchange Commission in analyzing and reviewing the financial statements and the financial health of the primary dealers to which the new facility is available. There are very high standards for becoming a primary dealer, so it's a limited number of institutions with which we have had a long-standing relationship that now have access to this facility. We only make loans on a fully collateralized basis, and it is going to be an issue going forward that Congress will need to consider whether there will be additional regulatory authority needed if this facility were to continue.

The CHAIRMAN. The gentlewoman from Illinois, Ms. Biggert.

Mrs. BIGGERT. Thank you very much, Mr. Chairman. And let me just say that I have a real concern that while the House and Senate leadership are engaged, it seems, to outbid each other on how much taxpayer funding they can spend to bail out various actors, that I think we should instead being passing FHA reform, GSE reform, and the other basic reforms that can start to help homeowners now. And my hope is that the leadership will move what is right in front of them instead of grasping, looking for new giveaways that may or may not help those who are actually now in trouble.

With that said, I want to turn to FHA Secure, and I would really like to compliment Mr. Montgomery and HUD for their work on FHA Secure and for already helping 150,000 families to stay in their homes, and for projecting that they will help 400,000 families by the end of this year. Congratulations. I think you are doing a great job.

I have a question for Mr. Kroszner and for Mr. Montgomery. In your testimony, Mr. Kroszner, you mentioned the importance of Congress giving FHA the flexibility to price FHA loans, especially loans being refinanced through FHA Secure. Why is this flexibility necessary? And do any of the current FHA modernization proposals under consideration provide FHA with the flexibility it needs to a risk-based price so that the FHA can serve more borrowers without jeopardizing the financial stability of the program and putting taxpayers on the hook for the money?

Mr. KROSZNER. Well, I think very much consistent with the last part of your question, that is the reason for thinking about risk-based pricing. Just as in the private sector, people who are riskier drivers have to pay higher premia; if you are a riskier borrower, you will have to pay a higher insurance premium in order to get a mortgage, all other things being equal. And if the FHA is going to be a world class mortgage insurer, it needs to have that flexibility to charge a higher price when there are more risks and also to charge a lower price when there are lower risks. And so this should be a very important part of any FHA modernization and reform proposal.

Mrs. BIGGERT. And so this can be done without legislation? FHA Secure?

Mr. KROSZNER. Well, FHA Secure certainly is being undertaken without further legislation. I believe there are statutory limits that exist in current legislation, and I know the Administration and Mr. Montgomery have been thinking of ways to deal with greater flexibility within those limits.

Mrs. BIGGERT. Okay. Now, Mr. Montgomery, do you want to comment on the flexibility?

Mr. MONTGOMERY. The pricing flexibility is key going forward, especially if we're going to take on more risk. And I do want to say that in the House bill that passed on FHA modernization, a lot of the pricing categories were not way off between what this committee has passed, and I thank you again for that.

I do want to say going forward, though, that it is an interesting dynamic that the borrowers in FHA's world who have the higher FICO scores—above 680—are our lowest income group. I know that seems counterintuitive, but they are the hard-working families who save their money for the downpayment, and enjoy the many benefits of FHA. Our proposal we're going to submit soon is a little different than we originally were going to do administratively. But we just want to give those families a small little price break, going forward.

Mrs. BIGGERT. So for those families to refinance, they will have to come up with more of a downpayment?

Mr. KROSZNER. For some families going forward, especially, again, as we take on more risk, yes, some of those would go to our statutory ceiling, which is 2.25 percent.

Mrs. BIGGERT. Thank you. Then, Mr. Kroszner, you also talked about FHA needing substantial flexibility in providing incentives to the servicers to negotiate with junior lienholders. Does Congress need to provide FHA with this flexibility? Or does FHA already have the authority to do that?

Mr. KROSZNER. That is, I think, a legal question that I am not sure of the answer to. I think it's perhaps—Mr. Montgomery would know the specifics better.

Mrs. BIGGERT. Mr. Montgomery?

Mr. MONTGOMERY. If you could repeat that? I'm sorry.

Mrs. BIGGERT. It's just whether you have the authority to negotiate with the junior lien providers.

Mr. MONTGOMERY. Certainly. That would be whatever, between the current mortgagor and the mortgagee, because certainly whomever is holding that second lien has a stake going forward as well.

Mrs. BIGGERT. But you could negotiate with them?

Mr. MONTGOMERY. Certainly.

Mrs. BIGGERT. Without legislation?

Mr. MONTGOMERY. Let me triple-check that for you, please.

Mrs. BIGGERT. Thank you. Yes, my time has expired.

The CHAIRMAN. The gentleman from California, Mr. Baca.

Mr. BACA. Thank you very much, Mr. Chairman. My question is for Governor Kroszner and Mr. Montgomery. One key issue is the extent to which voluntary loan modification programs are working. The New Hope Initiative, for example, is shared by Secretary Paulson, and is widely cited by industries as evidence of good work. While it is good that they got everything together, the fact is that voluntary programs aren't working.

So my question is what impacts have the voluntary loan modifications had on the efforts of reduced foreclosure rates? That's question number one. Number two, are there other efforts the regulators are pursuing to help families retain their homes? Governor Kroszner first, and then Mr. Montgomery?

Mr. KROSZNER. There has been some progress that has been made. The number of modifications has gone up. But as we were discussing in some of the earlier questions, the HOPE NOW Alliance Focus initially was on the resets. The resets are less of a challenge now for a variety of reasons, including the reduction in interest rates that the FOMC has undertaken. Because now the most—the so-called 2/28 and 3/27 subprime mortgages would reset to a fixed amount, usually 600 basis points, over a short-term interest rate. Now that we have taken the short-term interest rates down significantly, the payment shock has been mitigated dramatically, and so it's now in most cases—or I should say on average less than 1 percentage point. So that has been helpful.

We have been undertaking a number of other programs with NeighborWorks America, on which a number of us sit on the board, to try to expand counseling programs, to try to deal with real estate challenges after the properties go into foreclosure. The regional Federal Reserve Banks, all 12 of them, have very active programs working with local governments and local community groups to try to keep people in their homes, to try to provide counseling services.

And so we have been doing a lot in a lot of different areas, and continue to do a lot, and more needs to be done.

Mr. BACA. Mr. Montgomery?

Mr. MONTGOMERY. FHA Secure has been a part of the options available to people going through the HOPE NOW Alliance, and again borrowers contacting us on their own. Before today we required 6 months on-time payments before the interest rate reset; that was one of the barriers that we heard in the comments as to why families wouldn't qualify. And again with our announcement today, we are making exceptions to that, going forward.

Mr. BACA. Thank you. The next question I have is for Sheila Bair and for the Honorable John Dugan, and of course John Reich. Minority communities have been disproportionately affected by the downturn in the housing industry due to the large number of recent first-time homebuyers and the wide-spread use of subprimes and Alt-A loans among minority homebuyers. Additionally, the foreclosure rate of subprime loans has had a disproportionate impact on minorities and has put our communities at risk for losing their homes.

The question would be: What polices or procedures and incentives can we anticipate your respective organizations are developing as part of the CRA in a fair lending examination process to ensure disciplatory and financial institutions assist depressed borrowers to prevent foreclosures? Any one of you three may answer. And then, I have a second question.

The CHAIRMAN. We won't have time for a second question.

Ms. BAIR. Well, Congressman, you're absolutely right. The disparities that we see in neighborhoods that are getting high-cost loans are completely unacceptable, if you look at the HMDA data. We are trying to tackle this through a variety of means. First of all, working with the other regulators, we issued subprime guidance to address the abusive nature of many of these products. The Federal Reserve Board has proposed rules under the Home Owners Equity Protection Act, applying stronger lending standards across-

the-board. We have commented on those. One of the issues tackled there is yield spread premiums, which affirmatively, I believe, give incentives to steer people into higher cost loans. I think we should aggressively address that.

We are having a conference this summer, in July actually, on responsible ways to serve low- and moderate-income communities with mortgage lending—getting away from these abusive payment shock products, getting to fixed-rate mortgages, those that do not have payment shock, that are affordable. There are other product innovations, such as shared equity, extended amortization, where we believe you can, in a responsible way, make mortgages more affordable to low- and moderate-income communities. But it needs to be done the right way.

And finally we are looking very aggressively at CRA, to determine whether we should look at both quality as well as quantity of lending that qualifies for CRA, and whether a broader range of financial services needed by lower-income communities is adequately addressed under CRA.

The CHAIRMAN. We have time for either the Comptroller or the Director. Comptroller? Please.

Mr. DUGAN. Just in direct response and very quickly, I have in fact given a speech in support of expanding CRA to widen its scope to cover distressed mortgage communities in a broader array of circumstances that I think could help address this. And in addition, this committee has passed legislation that has expanded the public welfare investment authority of national banks, and so has the full House; it's still pending in the United States Senate. But if we could get that legislation passed, it would also help bring, we believe, even more investment from banks to distressed communities, and particularly minority and low-income communities.

Mr. BACA. Thank you.

The CHAIRMAN. Let me just clarify that when we talk about public welfare, we are talking about giving the banks more ability to do housing and other community-related activities, which has become a constraint. How will it take the—quickly please.

Mr. REICH. I could be mistaken about what I'm about to say, but I believe that we have authorized our financial institutions that we supervise to give double CRA credit to investments in low- to moderate-income communities, which would include, of course, many minority communities.

The CHAIRMAN. But let's put it this way, Director, if you were mistaken, you won't be tomorrow, because you could do it. So, we will consider that as done.

The gentleman from Georgia, Mr. Price.

Mr. PRICE. Thank you, Mr. Chairman. Before I begin, I would like to ask unanimous consent to include in the record a recent Wall Street Journal article from April 3rd of this year, entitled "Uncle Sub-Prime."

The CHAIRMAN. Without objection, it is so ordered.

Mr. PRICE. I know it is hard to believe, but I, for one, am proud to live in the greatest nation on the face of the Earth, a nation that has created more prosperity for more individuals across all demographic sectors of society than any nation in the history of the world. I think it is important that we put things in context, espe-

cially as we hear some of the dour predictions and dour assessments on the need for remarkable intervention by the Federal Government. We have been the most prosperous nation ever in the history of the world for a reason. If we meddle with that reason, we risk significant changes to our society and to the opportunities that all Americans currently enjoy.

I was meeting with a group of high school seniors, bright high school seniors last week, and they wanted to know about the housing crisis, and I asked them what percent of individuals do you believe who currently hold a mortgage are current on their payments? These were bright high school seniors, and the highest anybody would give me was 17 percent—17 percent.

The media has been adept, as have many in Congress, at a remarkable, remarkable misrepresentation of the entire market. Ninety-two percent, as you all know, are current on their mortgage right now. Ninety-two percent of homeowners in this Nation are current on their payments.

There has also been an impression that nothing has been done, that the FHA—that none of you at this table have done anything to try to assist Americans and homeowners across this Nation. Just to highlight a couple of items, in August of last year, FHA Secure was launched. As of March 19th of this year, 126,000 homeowners have been assisted, and they expect to help more than 300,000 families by the end of 2008. In October, the HOPE NOW Alliance was formed, a group of lenders, investors, and mortgage counselors working to help keep Americans in their homes. Since July of last year, they have assisted more than a million homeowners The number of borrowers receiving help is now rising faster than the number of foreclosures. We may be seeing some significant effect of the work that has already been done.

The Mortgage Forgiveness Debt Relief Act of 2007 was signed into law on December 20, 2007, protecting individuals from higher taxes as they refinance, and on, and on, and on. The Fed has attempted to increase liquidity. Project Lifeline was announced with HOPE NOW in February of this year.

So the question really becomes to us what else needs to be done, if anything? As a physician, I am always reminded that if I don't make the right diagnosis, it is difficult to treat the right problem. Some on this panel, on this committee, have talked about the excessive and dangerous deregulation that has occurred in the past.

Governor Kroszner, I was interested to read about the Boston Fed Reserve recently studying or determining that they felt that much of the challenge that we currently have is due to declining housing prices, as opposed to the excessive "deregulation." I wondered if you have any comment about the input of those two items in terms of the challenges that we are currently facing.

Mr. KROSZNER. Well, if I recall correctly, the Boston Fed study was not looking at the broader question that you're trying to address on the role of regulation or deregulation, but trying to look at some more narrow issues on is it interest rate resets, is it house price changes, is it a number of sort of economic, current economic factors.

And so what they determined is that housing price changes are really a primary determinant, at least in the data set that they had

looked at, for driving the foreclosure and delinquency rates. I don't think they were addressing the bigger question that you are raising.

Mr. PRICE. And would you care to address that bigger question?

Mr. KROSZNER. I think that is one that is a very, very difficult one to address but an extremely important one to address, to try to bring together the data and analysis to try to understand exactly what were the issues that may have driven some of these challenges. And I don't have a specific answer for you today.

Mr. PRICE. I thank you. I would be interested in the thoughts of the Board as we move forward. In my brief time left, I would like to ask Mr. Montgomery about legislating specific underwriting standards and decreasing the ability of FHA or anybody to look at risk in terms of covering a mortgage.

Mr. MONTGOMERY. You know, one of the reasons we were championing FHA reform way back when is there were some things that were set in statute that I, as Commissioner, was performing, did not have the ability to change, because they were set in statute. And we would like to keep underwriting as part of that—those things that the FHA Commissioner going forward would have the flexibility to change. The same on premium pricing structures. Certainly Congress, through our normal reporting channels, would have a say in that process. But I think going forward, flexibility is a key thing, whether it's underwriting, setting premiums and the like.

Mr. PRICE. Thank you.

The CHAIRMAN. The gentleman from North Carolina will be our last questioner before we break.

Mr. MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman. I don't want to talk about the turmoil in the markets. I want to talk about the original sin of our mortgage lending problems now, and what it did to borrowers.

First, about fraud. The question that Mr. Hensarling asked earlier about fraud and mortgage lending, the statistics I have seen are that the subprime loans made in 2006–2007 when things went to hell in a handbasket, that 43 to 50 percent of those loans were made without full income verification, full income documentation. Is that correct? Is that range about right?

[Panel nods in the affirmative]

Mr. MILLER OF NORTH CAROLINA. Now, it is very easy to document income for a mortgage. You can get employer verification. You can show a wage statement. You can show your tax returns. You can show bank statements, and you pay more if you don't fully document your income. You pay a higher interest rate if you do not—does anyone really think that the New York investment banks that were buying these mortgages to securitize them really had no clue something was up?

They were really getting half of all loans, subprime loans, without full income verification. And the people who were taking out those loans were middle-middle to lower-middle class. They weren't investors. They weren't self-employed. They didn't own a business. They weren't professionals. They worked for an employer who paid them wages. The easiest possible income to verify. Do any of you

really think that no one buying those loans really had a clue that there was a problem there? Chairman Bair?

Ms. BAIR. I don't think they looked. It's amazing to me. Investors were holding the ultimate risk in these loans, and I don't think they looked. I don't think the rating agencies looked. It is one of the breakdowns of the system we have that that market discipline was not there. Nobody was looking.

Mr. MILLER OF NORTH CAROLINA. Okay. Does anyone here think that the masters of the universe on Wall Street who bought these loans really were played for chumps by the middle-class families who were borrowing?

Mr. DUGAN. If I may?

Mr. MILLER OF NORTH CAROLINA. Mr. Dugan?

Mr. DUGAN. Yes. What I would say is this: I think there was this belief that income was no longer predictive of people paying their loans back, that you could rely on this history of house prices going up. And so they ignored it. And I think that proved to be a very dangerous decline in underwriting standards.

Mr. MILLER OF NORTH CAROLINA. Well, and in fact the reason for that was—no one involved in mortgage lending, in subprime lending, expected for a second that people would actually pay off those loans over the course of 30 years.

The loans were designed to become unaffordable, become unpayable, so that people would have to borrow again. And when they borrowed again, they would have to pay a prepayment penalty to get out of the last loan. They would have to pay points and fees cost to get into the next loan, and every time they did it, they lost more of the equity in their home. That was the intent, that was the design. What went wrong was not that people couldn't pay the loans according to their terms. What went wrong from the industry point of view was that the housing prices stopped appreciating and you could no longer count on people getting out, either refinancing or just selling their house.

These loans were not about homeownership. That is one of the claims made, the arguments made is that these were loans that were made to allow homeownership for people who otherwise would not have qualified for traditional mortgages, and what we have seen, in fact, is a decline in homeownership.

The rate, according to the Census Bureau, for the fourth quarter of 2004, was 69.2 percent. For the last quarter it was 67.8 percent. When the figures come out for last quarter, first quarter of this year later this month, it's going to be down again, down again in the second quarter, down again in the third quarter, down again in the fourth quarter. It will continue to decline.

Those are millions of American families who owned a home and no longer own a home. The worst cases were the foreclosures. There are also a lot of people who sold their homes, could sell their homes, had some equity still, could sell their homes, who quietly sold their homes, and a lot of them are embarrassed about it, because they couldn't pay the mortgage.

And then finally, the question I have is about the millions of American families who were able to get out but were stripped of the equity by equity-stripping practices like prepayment penalties. Do you—what I have seen is that the lenders have only agreed vol-

untarily to what is in their obvious self-interest. But they continued to enforce equity-stripping provisions where they could extract the money still from the borrower. Should we pay some attention to what is happening in the other loans when we agree to buy some of the loans, the ones that obviously cannot—are not being paid?

Ms. BAIR. I'm not sure—

The CHAIRMAN. The gentleman's time has expired. Maybe he can submit it in writing and get an answer, but we are out of time.

Mr. MILLER OF NORTH CAROLINA. All right.

The CHAIRMAN. And we have to go vote. Why don't we—the gentleman from North Carolina will submit that question in writing, and we would like an answer for the hearing record.

Ms. BAIR. Could I—

The CHAIRMAN. Ms. Bair, quickly.

Ms. BAIR. Just to respond briefly. The FDIC is opposed to stated income. We think that should apply across-the-board. We are suggesting that you get rid of prepayment penalties completely, and also that we think all originators, bank and non-bank, should underwrite at the full indexed rate to make sure that the borrower can make the reset rate. I just want to make sure we're on the record.

The CHAIRMAN. Thank you. We will be in recess for 35 minutes. And 2 words of encouragement—fewer members. We will ask you to stay if you could for—we will be gone about 35 minutes probably, and then we will come back and finish up. Fewer members come back, so it will be quick. There are three votes. I would say we will be back here in a half hour or less.

[Recess]

The CHAIRMAN. We will reconvene. I apologize for the delay. I got stuck trying to get an elevator. We will now hear from the gentleman from Delaware, Mr. Castle, for 5 minutes. Please take your seats.

Mr. CASTLE. Thank you, Mr. Chairman. Comptroller Dugan, I was not here for your testimony. I had to duck in and out to another markup at another meeting, but I have read your testimony, which I understand you did not discuss orally, with respect to legislation which I have been involved with, which is H.R. 5579. It's on pages 7 and 8 of your testimony.

And basically, without spending all our time summarizing the legislation, it sets standards by which—the legislation would set standards by which lenders, who may be assignees or whatever of the mortgage, could renegotiate the mortgage terms with the borrower. And, obviously, if they could meet those standards, they could use that in defense with respect to possible litigation.

This would be open for some period of time, and it essentially would I think serve the purpose of allowing the individual lenders or assignees of the mortgages or whatever to be able to sit down and negotiate terms that might be favorable to the borrowers and perhaps lock in a lower rate or a different rate than the lower rate and whatever the adjustable rate may be.

But from experience in this area, it seems to me that nobody wins in a foreclosure. Clearly, the banks don't want to take back property which may be worth less. Obviously, homeowners don't want to give up property. And the only issue that has been raised

by anybody that is somewhat negative to all this are obviously the downstream noteholders as they take the various mortgages and whack them up into principal and interest or whatever. I guess there are those who potentially could lose in all this, although I would argue that if you're going into a foreclosure, you may lose even more than you would if you had a reduced interest circumstance.

I would be interested in your comments concerning this legislation, which is not directly a part of the legislation before us, I don't believe, at this time, but it has been under discussion in this committee, as to the benefits of possibly doing this, either together with legislation that might emanate from this committee or separately, and legislation that might emanate from this committee, and in terms of any potential downsides that we should worry about in that legislation.

Mr. DUGAN. Well, Mr. Castle, we support this legislative effort, as I indicated in the testimony, and we have tried to provide some comments to your staff earlier before it got put in its current form.

We think it clarifies the basic principle that is already in the law, which is that when a servicer is acting to restructure a loan, that they do so on behalf of the whole loan pool rather than try to be guided by different interests of different investors in the pool that have different interests, under the principle that you can't serve two or three masters. You have to serve the whole pool at once. And we think your legislation clarifies that point, and we think it's helpful in that regard, because I think it does remove some of the ambiguity that people have had about this point. I think it would be useful to remove that friction point so that when it makes sense and services want to voluntarily enter into a modification that benefits the pool more than would be the cost of foreclosure, they should be able to do so.

Mr. CASTLE. And what are your—you sort of spoke generally to that, and I appreciate that, but what about the argument that there are those who would be hurt by it? That is, noteholders further down the line who would not receive what they might have received otherwise or whatever. Is there a response to that?

Mr. DUGAN. Well, I think the point again is it is different interests within the pool. And the issue is that I think the servicer can only act on behalf of the whole pool. They can't act on behalf of one group of investors and also at the same time serve another group within the pool that has a slightly different interest. It's just impossible to do both, and I don't think they're legally bound to do both now, although that could be different in different agreements. And I think this just clarifies that they can.

It will always be the case that if you have different interests in the pool, some will be hurt or harmed, depending on whether you go to foreclosure first or last. But you could have a situation where one investor would benefit by going to foreclosure, even though it would be more expensive to the pool as a whole, while another investor would never want foreclosure in the pool, just because of the way payment streams work. This is a simple test that says if the net present value of the savings by doing this is more to the pool than foreclosure would be, then they can go ahead and do it. And I believe that makes sense, and I think others do as well.

Mr. CASTLE. Thank you. I'm not sure if other members of the panel are even familiar with this, but does anybody else have any comments they wish to make on it?

Ms. BAIR. Yes. We are highly supportive of it. I think you and I actually discussed this some months ago in your office when the original bill that Chairman Frank was putting together was under consideration. And I think some of the political resistance, frankly, that you are running into now comes from those same senior tranche holders who have been pushing back before.

So I am disappointed, because the American Securitization Forum in June of last year said very clearly that servicers' obligations are to the pool as a whole. There are some who think this is an excuse and others who think it is real. I have heard it enough to think it's real. But clearly, servicers are concerned about potential investor liability. So I think this could be a carrot incentive to further the loan modification process along, and we're happy to keep working with you on it.

Mr. CASTLE. Okay. Thank you.

The CHAIRMAN. If the gentleman would—

Mr. CASTLE. I yield back, Mr. Chairman.

The CHAIRMAN. Let me just briefly say, and I want to repeat what I began by saying, we cannot order anybody to go along with this, and the gentleman's bill doesn't try to do that, because we're dealing with contracts already written. But I do want to make it clear to the American Securitization Forum and everybody else that if in fact we are not able to get substantial progress in this kind of voluntary situation, then I can pretty much guarantee them that going forward, they will face a very tough set of rules. If this can't be worked out voluntarily now with existing contracts, then it will be our obligation to give a set of rules and priorities for contracts going forward.

So I hope they will take the opportunity to work this out, because if they don't, I think you're going to see a more prescriptive regulatory framework going forward. It is not the ideal, but if that is the only choice, then that is what I think you will see pressure to do. And that is what I want to do. You never know. As this thing—if things continue to deteriorate, if the gentlewoman from California, Ms. Waters, gets into mitigation, then people are going to really get mitigated in ways they don't like.

[Laughter]

The CHAIRMAN. So, I do urge people to take this into account. The gentlewoman from Illinois, Ms. Bean.

Ms. BEAN. Thank you, Mr. Chairman. Thank you to our panelists for sharing your expertise on a very critical issue facing our Nation. My question to the panel is to address the moral hazard and recoup risk for the Federal Government. The chairman's bill has an aggressive exit fee structure in the first 5 years, 100 percent of equity gained in year one, up to 20 percent of equity gained in year five. After the fifth year, borrowers are assessed an exit fee equal to 3 percent of the loan amount.

Do you believe this fee structure is aggressive enough to prevent moral hazard and deter the perception of nonparticipating taxpayers that the government is unjustly bailing out troubled borrowers?

Mr. KROSZNER. The moral hazard issue is an extremely important one, and I'm glad you have emphasized it, and I'm also very pleased to see that the draft legislation tries to deal with it.

I think there are three pieces that try to deal with it. One is the exit fees that you spoke about, the 3 percent that whenever someone will leave the loan, they will have to pay that 3 percent. Second, that there's some sharing of the appreciation that would go on over a 5-year period. I don't think that is particularly set in stone, whether that's the exact appropriate level or not, is something that I think is open to discussion. But that type of feature is a sensible one to try to protect against moral hazard. And also that there has to be a high debt payment-to-income ratio before the legislation has been contemplated, and that there's no—you can't intentionally default to get into the program.

So I think there are a number of issues that are there. The exact levels of them, I can't tell you what the right levels are, but it's important to at least be considering those and thinking very seriously about them.

Ms. BEAN. Thank you. Are there any other panelists who want to comment? And I would also throw in that the Senate proposal has a 50 percent exit fee on equity gained, if you have a comment on the contrast between those two.

The CHAIRMAN. Will the gentlewoman yield briefly before they do, just for me to point out that—

Ms. BEAN. Certainly.

The CHAIRMAN. And certainly that is a serious issue. There is one other thing that we think deals with moral hazard, and that is the bill we passed last year, so that going forward, you are likely to have—we have a set of rules in place governing mortgage brokers and others so that there will be much less opportunity. In other words, it is not purely a disincentive. Many of the loans that caused the problems, there will be laws about there. So that is a piece of it.

Ms. BEAN. You're talking about the mortgage reform bill. Okay.

Ms. BAIR. I think like anything, it's a balancing act. If you give the borrower the prospect of getting 100 percent of that home price appreciation after 5 years, you have more of an incentive for them to stay—stick with that loan, perform on the loan, keep paying, but then you have—perhaps exacerbate potential hazard, so I think the Senate takes a different approach with only 50 percent equity. I think you can argue it either way.

I would point out, though, that there's a moral hazard with investors here, too, I think—but there's been a lot of focus on borrower moral hazard, and clearly that's, you know, an issue. But an 85 percent payoff of appraised value, there are probably still for a lot of loans getting paid more than they would if they had gone to foreclosure. And I think again one of the reasons why you have to have this writedown that creates this 15 percent equity piece to begin with is that you need to protect the government and also guard against moral hazard with investors.

So it's a balancing act. It's a complex process, but I think this bill does a good job of trying to juggle the different interests.

Ms. BEAN. Thank you. Does anybody else want to comment?

Mr. DUGAN. I would agree with both sets of comments. I guess I would just say, it's hard to know. We don't really have experience with which of the numbers that you set it at are going to work best. I think actually the FHA probably has the most experience about what over time has created the right incentives without creating undue losses and moral hazard.

Ms. BEAN. All right. I guess I would like to also comment that the chairman mentioned previous bills that we have passed to address this area. We did the mortgage reform bill; we had FHA reform and GSE reform. How important do you feel it is that we move forward on those as well? As the chairman said, we need to go back to moving forward on newly originated loans. What's your sense of urgency?

Mr. MONTGOMERY. Certainly on FHA reform—I am preaching to the choir on that issue, obviously—if I could just go back to your previous point real quickly, we're coming at it from a little different direction. We share in the goal that people shouldn't benefit or profit from this. We do want to keep the homeowner in the home. We would probably propose some sort of resale restrictions, some recapture provision, similar to what a lot of State housing finance agencies do. I think we share the same goal. We just conceptually might come at it a little differently.

Ms. BEAN. Yes?

Mr. DUGAN. On your other question, I think the most important part of the mortgage reform legislation, is that it basically takes the Federal standards that have been adopted by the bank regulators on guidance and it tries to extend them in a uniform way to all loans, not just loans originated by banks, but loans originated under the purview of State regulators.

I think that's the single most important part of it. And it's the single thing that really needs to go forward so we do have a uniform standard going forward. I think right now the market, frankly, has already adjusted. There aren't many subprime loans being made, but that will change someday, and when it does, we do want to be in a world where they're basically underwritten so that borrowers can repay their loans without having to rely on the price of their house going up.

Mrs. MALONEY. [presiding] The gentlelady's time has expired.

Ms. BEAN. Thank you. I yield back. I see I'm over my time.

Mrs. MALONEY. The Chair recognizes Congresswoman Capito for 5 minutes.

Mrs. CAPITO. Thank you, Madam Chairwoman. I thank the panelists for their length and depth of their answers. I would like to thank Mr. Montgomery for his dedicated service in trying to help us get this FHA modernization bill through. I know that many of us on this committee have worked on hard on that, and we are frustrated that we have not been able to reach an agreement, but I think this is giving us more impetus to keep moving forward on it.

In light of the fact that legislation probably will not be passed as quickly and in light of the fact of the announcements that you have made today to expand FHA Secure, which I congratulate you on finding a way to help another 100,000 homeowners, particularly those who might have some delinquencies, particularly those who

might have some extenuating circumstances, particularly those whose property's value is now way below what their loan is. And these are probably that get up probably in a panic every month trying to figure out how to meet their obligations. What is the timeline for implementing these administrative policies that you put forward today?

Mr. MONTGOMERY. Well, heretofore, we have charged a uniform premium and part of this proposal to make it work from an actuarial standpoint, as previously mentioned, is the risk-based pricing structure. FHA, as you know, is not the mortgage company, we are the mortgage insurer, so we operate through our network of FHA-approved lenders and certainly they have to make some systems changes to now as we define the various risk tranche and price those accordingly, probably anywhere from 60 to 70 days before we would be able to stand this up completely.

Mrs. CAPITO. Thank you, certainly it would be nice to think our legislation could move as swiftly but it looks like with the situation in the Senate, the Administration's position on that bill and then Mr. Frank's bill, it looks like we are probably going to have a lengthier discussion here.

One of the questions I wanted to ask you as well is a point that you brought up in your opening statement about the seller-funded downpayments and that FHA is the only organization that is still accepting that. Could you elaborate on that? And you mentioned that those who received the seller-funded downpayment assistance go to foreclosure as many as three times the rate of the loans made to the borrowers, could you explain that a little bit?

Mr. MONTGOMERY. Well, we have looked at similar years to what FHA has seen right now in terms of purchase and re-finance transactions, I will put reverse mortgages to the side for now. We went back and looked at the books of business from about 1995 to 2003, before the proliferation of the seller-funded, and to look at the credit subsidy rates and the claim rates, we did not have such a high percentage of our book of business as seller funded to a point in time where now we have about 33 percent of that, the claim rate almost doubled. In fact, it actually a little more than doubled. And our credit subsidy rate, which was averaging about minus 2.0, which as we know in government parlance, a negative subsidy rate is good, actually trended more positive. And there is probably a reason that no one else accepts this form of assistance because they have really hurt our ability to function and also have a lot to do with the fact we have to do this risk-based pricing.

The Internal Revenue Service has also addressed this issue, and we are going to continue to look forward because we need to be able to function without taxpayer support.

Mrs. CAPITO. Thank you. I just want to say that this issue is something that even though my State is 47th in foreclosure, the State of West Virginia, it has a cascading effect really in all areas of the credit markets and it is important that I think that we, as you and I mentioned in discussions before, that the floor is established so that we can then begin building back. So I thank you for your efforts in that behalf, and I would like to mention on behalf of my constituents, who do all of the IT for this program and for

HUD and for FHA, I have 100 people who are working hard and they are seeing the fruits of their efforts, so thank you.

Mrs. MALONEY. Thank you. The Chair recognizes Congressman Ellison for 5 minutes.

Mr. ELLISON. Thank you, Madam Chairwoman. And also let me join in thanking the panelists. Mr. Montgomery, in my City of Minneapolis, we have obviously a number of foreclosed homes and our Public Housing Authority would like to be able to acquire some of those homes and use those to fill the backlog they have for people who have applied for public housing. What is the public housing backlog like around the country?

Mr. MONTGOMERY. The public housing backlog?

Mr. ELLISON. Yes, for public housing and also these scattered site type housing as well.

Mr. MONTGOMERY. Sorry, I don't have the answer. Public housing is not under my realm, and I apologize.

Mr. ELLISON. But what about institutions like the Minneapolis Public Housing Authority being able to get loans from the government to get some of these homes to put people in them, do you think that would help advance the cause of trying to address this burgeoning housing issue we have?

Mr. MONTGOMERY. Certainly, Congressman. In fact, we have a similar program. Within the Federal Housing Administration, we have done pilot programs across America where we have a concentration but again I can only speak for the HUD-foreclosed inventory.

Mr. ELLISON. If a local housing authority were able to get loans to buy up these properties, would not that advance—would that not be something that Title 3 of the proposed legislation would help to correct, if they have the availability of that—if that was available to them?

Mr. MONTGOMERY. Certainly, again, I can only speak for the FHA inventory, but principally lenders would be benefitting, so many of these are government resources, FHA or otherwise, and I think we just need to be cautious. While we all want to see these homes, especially those that need some repair, be occupied, again we have to ask where would the source of funds come from to provide loans or grants.

Mr. ELLISON. I will yield back at this time, Madam Chairwoman.

Mrs. MALONEY. Congressman Garrett, for 5 minutes.

Mr. GARRETT. I thank the Chair and I thank the members of the panel as well. I appreciate your coming for this forum. I think it is important. I will begin where Secretary Montgomery was cut off at his initial testimony or answering a question. I think we all agree on the same point, that at the end of the day we want to do all that we can to address the situation to make sure that we have a secure system now but also our housing plans in the future as well.

When we look at the economy today, as we have it, it is somewhat clearer now that we may be moving into a recession. I heard the former chairman just on TV the other day, former Chairman Greenspan, saying that we are now moving into a recession, and so we have the experts telling us that and the folks on TV, Larry Kudlow, who was always the epitome of the optimist, whom I fol-

lowed up until 2 days ago when he went 180 degrees the other day and says he even agrees that we are in a recession now as well, so everyone is on the same page, I guess, to that extent.

But even when you move those words away, when I look at my constituents back at home, however you define it, they are hurting. I am from the State of New Jersey and it is not just the housing situation, we are a commuter State, so we are paying at the pump continuously. And just in this session alone we have seen the price of gas go up by almost a buck and so when you are in a commuting State, you are seeing your cost of living going up. That is tied of course to other energy costs, and food prices are going through the roof. Mr. Kroszer, you can probably tell us about the inflationary pressures, and I could probably have a debate with you as far some monetary policy on that as well, but we see the inflationary pressures just impacting the family budget in so many ways and housing then is just—these housing prices just exacerbates it.

But what you miss sometimes, I think, or the media misses sometimes is that on this housing situation, things have been done already. The Administration came out with a program a while ago to remediate the situation. The Administration has a new proposal now. This committee, of course, has done—we just discussed the issue as far FHA reform and the private sector, I believe, has also stepped up to the plate to a pretty large extent as well to address it. I am wondering, besides the proposal on the table right now, and, Chairman Bair, I will throw this out to you, are there other avenues that we should be looking at specifically that might be in your bailiwick, if you will, to provide some more credit relief in a way that would address the overall economic situation and maybe indirectly to this and that is in the area of covered bonds. Could you bring us up to date on what you are doing and what the outlook calls for that?

Ms. BAIR. Sure. Well, actually, we will be having a board meeting next week, and I expect the Board will be putting out for comment a policy statement to facilitate more covered bond offerings here in the United States. It will help. It is not a magic bullet, but I think it will help provide some additional capital market liquidity given the problems the private label securitization market has had. We think it is a mixed bag for the FDIC. If a bank who does the covered bond offering would eventually get into trouble, it would increase our resolution costs because these are secured offerings. It removes some high quality assets that we could otherwise sell off.

Mr. GARRETT. Okay.

Ms. BAIR. But that is a fairly remote possibility. I think for the institutions that we are looking at, who would probably be interested in doing this, we will be building in some conditions such as primary regulator approval in order to make the covered bond offering. But I think it is something we should facilitate.

On the positive side from a regulatory standpoint, those mortgage assets do stay on banks' balance sheets, so hopefully there is more underwriting discipline than we have seen in the securitization market. Also they would have to hold capital against these assets, whereas if they are securitized again, they move off balance sheets. So I think there are some positives from a supervisory standpoint and certainly anything we can do to help provide

liquidity for mortgage funding right now is something we want to encourage.

Mr. GARRETT. Two quick questions: First, is there a timeline on any of this; and, second, is there any legislative action that we should be working with you on this end?

Ms. BAIR. No, I don't think so. I think this is something we can do by regulation, by policy statement and, as I said, the FDIC Board will be formally considering this matter. I have two of my Board members here with me, but I think it is generally known publicly that we are going to be moving ahead with this. The Board will vote next week and it will be out for comment for a period, but I think just the fact that we put it out will immediately send a signal to banks that might want to do these and provide information to rating agencies regarding what the conditions are.

Mr. GARRETT. Okay, if there is anything we can do on that, please let us know.

Ms. BAIR. I will.

Mr. GARRETT. And my final question in the time remaining is, the action that we are doing here and continuing the debate on this, does this do anything to the broader marketplace which is basically holding their assets on the sidelines at this point as far as the credit markets are concerned and saying we are really waiting to see what Congress does, all the time keeping the credit market tighter than maybe it should be, do any of you have an opinion that we may be exacerbating this problem, if you will, by just continuously throwing out new proposals and not moving—either not moving on them or just continuing the debate?

Mr. REICH. I do believe that servicers may be among those that are waiting to see what is likely to come from current discussions. We have been talking with them about a proposal that we put on the table that is very similar to the chairman's proposal but it includes a negative equity piece that would offer to servicers the opportunity to hold the amount that is underwater and opportunity to recoup the potential value on down the road when the house is ultimately sold. Providing the servicer some incentive, in our opinion, is one of the keys to incentivizing them to be more aggressive in offering and working with the borrowers that are within the securitizations.

Mr. GARRETT. Anyone else?

The CHAIRMAN. Thank you.

Mr. GARRETT. Thank you.

The CHAIRMAN. The gentleman from Colorado?

Mr. PERLMUTTER. Thank you, Mr. Chairman. And, Mr. Montgomery, I appreciate your comments about looking out for the taxpayer, you have to do that in your organization, and we have to do that as Members of Congress. But the FHA is not an island unto itself, and so I want to start with Chairman Bair and just ask if we do not do anything, and I see that there are some pitfalls to the legislation the chairman has proposed, but if we do not do anything, how many claims do you think are going to be made against the FDIC?

Ms. BAIR. Congressman, as a matter of policy, I really do not make those kinds of predictions, but I do think we are in a very serious situation here. It may sort itself out sooner rather than

later. We do not know. There are a lot of uncertainties, but I think the situation is getting serious enough that we do need—as I said in my written and oral statement—to be more proactively instituting government programs to try to stabilize the situation.

Mr. PERLMUTTER. And really, again, Mr. Montgomery, that is where I am coming from, having been a product of the 1980's, the RTC and the FHA suffered some pretty heavy losses during those years as well. Ultimately, the taxpayer of this country steps behind things and so when the Federal Reserve steps in to underwrite $30 billion for Bear Stearns because at the heart of it was mortgage-backed securities that seemed to be questionable for everybody, I feel like we have already stepped in on Wall Street, so we better also help on Main Street to some degree. So I am going to ask the Governor, of the $30 billion, and I understand that there is $1 billion that JP Morgan is on the hook for and $29 billion that the taxpayers may be on the hook for, what if we do not do anything, how solid do you think your $29 billion underwriting of Bear Stearns is going to be?

Mr. KROSZNER. Well, this is, as you said, exactly why we wanted to put the acquirer in the first loss position on the first $1 billion. We have hired an expert on doing valuation, and we are assessing that. We believe that good collateral has been pledged, but obviously we will depend on the evolution of the markets over time to know what the extent of payouts are, either positive or negative.

Mr. PERLMUTTER. And if I understood that particular deal, the underwriting comes at a figure where there has been a write-down of the Bear Stearns assets, right, to market at this time? We do not know if it is going to get worse or better or whatever.

Mr. KROSZNER. Yes, a haircut has been taken on the assets.

Mr. PERLMUTTER. And as I understand the chairman's bill, there would be a haircut or write-down or whatever to some appraised value, and I feel sorry for the appraisers in this deal. There is a lot of pressure and, Mr. Chairman, I do not know—I am concerned about the pressure that is placed on the appraisal industry, whether it is independent or within the institution, to establish that market price. But here, and Mr. Montgomery, this is my question to you, if there is this write-down to market and then 90 percent of that is guaranteed, I understand there is some risk to the taxpayer if in fact the market continues to fall, but I am sure—how in what you are doing, in what the Administration has proposed is there any less risk than what is proposed in this bill?

Mr. MONTGOMERY. Well, there is certainly risk with the existing FHA portfolio, the non-subprime part that we are talking about assisting more of, so we have that concern today. Again, I think we share some of the ultimate goal that there needs to be some sort of write-down to get to a more realistic number in between, whether it is 85 percent LTV or 90 percent LTV, again, based on actuarial modeling, those loans perform fairly well for us. I would say the timing is probably good for these. My opinion is, I think prices may go down a little more, but I think we are kind of near the bottom of that trough, and I think we all want prices to go back, maybe not the run-up we just saw, but the timing might be good for doing this type of proposal.

Mr. PERLMUTTER. Okay, and I guess the last comment, and this is to you, Mr. Comptroller, I think one of the biggest problems that I have seen here is just the way, whether it is Bear Stearns or how it was capitalized in this thing, whether it was a 1 percent, you can borrow 99 percent against the 1 percent on these mortgage-backed securities, and so I just think there needs to be some stiffer regulation within the capitalizing these mortgage-backed securities, and I yield back.

The CHAIRMAN. The gentleman from North Carolina, Mr. McHenry?

Mr. MCHENRY. I thank the chairman. I do want to start by saying I disagree with my colleague. I believe that we should not feel sorry for the appraisers; they are going to make a mint under this House bill. Talk about pressure, their pressure will be being able to get enough hours in the day to process all their checks. But I digress.

Mr. Montgomery, in terms of FHA action, I wanted to bring up an article, a recent Wall Street Journal article entitled, "Uncle Subprime." It contends that Mr. Frank's bill waters down the FHA underwriting standards, namely, "Borrowers cannot be denied FHA insurance due to low credit scores or a delinquency on existing mortgages. It also cannot be the sole reason to deny FHA insurance."

In the fourth quarter of 2007, FHA, you all were the only component to see a decline in foreclosures in the mortgage market, isn't that correct?

Mr. MONTGOMERY. That is correct. It has gone up and down a tenth or a hundredth of a percent but very little.

Mr. MCHENRY. Okay, but it is less than the rest of the mortgage marketplace.

Mr. MONTGOMERY. Way less than subprime, it is about 2.15 right now.

Mr. MCHENRY. But less than the whole rest of the marketplace. So how would you expect this rate to change under the chairman's mark, this discussion draft before us?

Mr. MONTGOMERY. Well, the beauty of FHA for decades has been there is no FICO score requirement. There is not one FICO cutoff. We look at the totality of what the borrower's portfolio is. I would say we are looking at risk identifiers maybe a little differently. We are more concerned about the number of delinquencies going forward. I think the chairman's bill is looking at it from a DTI aspect as well, which we are doing similarly. But, again, I do not think we are looking to throw the baby out with the bath water here in underwriting. We are going to continue to put some parameters around who qualifies and who does not, and there will be some who will not qualify.

Mr. MCHENRY. How would you expect the rate of foreclosures, would it go up or go down, under the legislation before us in the House?

Mr. MONTGOMERY. I think given the narrow constraints that we are putting on, again, I cannot control market dynamics, but as our foreclosure rate does and has for many years, sometimes it will uptick a little, sometimes it will go back down. I cannot see that it would measurably change a lot one way or the other.

Mr. MCHENRY. Okay.

Mr. MONTGOMERY. At least in the short term. That is just my opinion.

Mr. MCHENRY. So just a guess is what you are saying, okay.

Mr. MONTGOMERY. A little better than a guess.

Mr. MCHENRY. Okay, but based on my reading of it, it looks like the underwriting standards would be watered down based on legislative action and FHA would be forced to ensure loans that they normally would not and that is a contention that we will make.

But I will go on to Governor Kroszner. We have some discussion today that Citigroup—there is a report today that Citigroup has $12 billion in loans. A private equity firm has stepped forward and offered them 80 cents on the dollar. How would this proposal from the House affect a proposition like that? Could this private equity firm in fact make money off of this proposal? Instead of being worth 80 cents on the dollar, it would be worth 85 cents on the dollar?

Mr. KROSZNER. Well, I cannot comment on anything specific to this transaction because I do not have any details on that, but the issues that you raise are important ones because we do not want an adverse selection problem where the government only gets the bad assets, or a moral hazard problem to arise. And so that is why it is very important in contemplating any such legislation, that there are very important ways of trying to deal with some of the adverse selection problem. One way of doing that is giving more flexibility to the FHA to do risk-based pricing, so that if a riskier loan comes to them, they can charge a higher premium, just as in the private markets, if you are a riskier driver, a higher premium is charged to you. And there are a number of aspects of the proposal that I think are in important in thinking about that.

One thing that is done very often in the private sector is a so-called loan seasoning or put-back provision so that if a loan is sold to someone else, here it would be sold to the FHA, if it were to go delinquent very quickly within a few month time period, it could be put back to the person who gave it.

Mr. MCHENRY. Sure, you mentioned that earlier in your testimony. Is the private sector beginning to sort out some of this debt question? Are there groups being formed that are trying to do some assessment of purchasing some of the loan packages, mortgage packages, and trying to make some profit by doing some workouts by purchasing this?

Mr. KROSZNER. Again, I am not familiar with any particular circumstances.

Mr. MCHENRY. Sure, well, Ms. Bair, if you could comment on that, and I appreciate your rapping the gavel but she was interested in answering.

The CHAIRMAN. We generally allow the last answer. Go ahead.

Mr. MCHENRY. Well, Ms. Bair is the last answer, thank you.

The CHAIRMAN. Ms. Bair, please go ahead.

Ms. BAIR. Yes, I just want to add that I think those were leveraged loans that were sold; I am only familiar with the published press accounts. Those are corporate loans, they were leveraged loans, they were not mortgage loans or mortgage-related assets, so I just wanted to make that clarification. In terms of whether mort-

gages or mortgage-related securities are finding their bottom, so to speak, the economic analysis that I am getting from our staff indicates that we are still looking at very, very steep discounts. Home prices themselves continue to go down. We had very steep declines last year, in some areas 15 to 20 percent, and the futures markets are still predicting declines as well as most of the analysts I am reading. So I think for housing and housing-related assets, there are a lot of uncertainties about where this is still going to go.

The CHAIRMAN. The gentleman from Illinois? Let me ask the gentleman to yield me 30 seconds first. The gentleman from North Carolina talked about weakening of standards and delinquencies. The changes that are proposed permit a borrower—because now delinquencies keep you out of this—permit a borrower to have either one 60-day delinquency or two 30-day delinquencies if it is 97.75 LTV, and permit borrowers who exceed such delinquency histories with extenuating circumstances.

The proposed changes also permit borrowers who only borrow 90 percent LTV to have as many as one 90-day delinquency or three 30-day delinquencies. That is the FHA's proposal from the Administration. So the tolerance for delinquencies, and I appreciate the Commissioner's answers, what I have just read would be a weakening of standards, if that is what you want to call it, which is the Administration's proposal.

The gentleman from Illinois?

Mr. FOSTER. I would like to thank the panel for staying around to the point where you are now listening to the first-ever questions from a 3-week old Congressman.

[Laughter]

Mr. FOSTER. The first question has to do with the regional and State balance and mortgage relief. In the discussion draft, the allocation of grant amounts and loan authority goes preferentially to States first that have high real estate prices because they are scaled to the median home price. And, secondly, to States that have a high fraction of failing mortgages since they are scaled to the total number of mortgages in trouble or foreclosure. The problems that occur to me are that, first, you are allocating funds preferentially to States with high real estate prices, and so maybe you are not allocating funds in a way to help the greatest number of people since it presumably is cheaper to bail out homeowners in low-cost real estate markets than in higher cost real estate markets. And in a related issue, you are implementing what amounts to a differential Federal subsidy, which has the effect of supporting real estate prices in areas where the prices are already high and thereby making a bigger spread in real estate prices than the market might normally support.

And the second problem that I have with this is that if you allocate funds to States with high fractions of bad mortgages, then you may be creating a State-by-State moral hazard in which States that have lots of bad actors in them get a preferentially large bailout. And I was wondering, this sort of discussion has to come up over and over again in things like the FHA and if any of you have comments on this, how it is handled and whether there are issues are that could be handled differently?

Ms. BAIR. Congressman, I used to work in the Senate for many years for Bob Dole and one thing I learned is never get involved in congressional debates about where money is allocated among States, so I think you raise legitimate issues, but I think it is really more one of congressional policy than it is regulatory or supervisory issues.

Mr. FOSTER. Fair enough, okay. I will ask a hopefully simpler question, which is that when this is all played out, would we have been better off to simply ban ARMs or maybe reduce the range over which they can be reset?

Ms. BAIR. I think that is an excellent question. I think what the bank regulators have told the banks is that they underwrite loans at the fully indexed rate, meaning you can do an adjustable rate mortgage but you need to make sure that the borrower has the income to make the reset. The Federal Reserve Board has proposed similar rules that would apply to all mortgage originators, not just banks. So, yes, adjustable rate mortgages may be a good product, but the underwriter—the originator—needs to make sure that the borrower can make the reset rate when the payments adjust up.

Mr. DUGAN. I would just add that I do not think it is a good idea to ban adjustable rate mortgages. There have been many that have been very good consumer products that have saved consumers a lot of money. Some have performed better than others. I think it has really been the underwriting features, as my colleague just suggested, that have been the big problem with this, and I think adjusting the underwriting standards through guidance and through regulation is really the fundamental way to get at this.

Mr. REICH. I agree with that. I think that banning specific products is not a good idea. I think that you could name almost every product and find that there is significant responsible borrower utilization of those products and it is the underwriting on which we need to focus our attention.

Mr. FOSTER. Okay, I yield back.

The CHAIRMAN. I would ask the gentleman, since we have some time, on the first part of the question in terms of the State-by-State allocation, I just want to be clear, with regard to buying up property that is already foreclosed there is an allocation, but in the first part, there is no allocation formula. The part about the FHA, going to the FHA, there is no State-by-State allocation formula. The State-by-State allocation—

Mr. FOSTER. I believe that there is language in there that indexed, this index that was constructed related to the average—

The CHAIRMAN. Yes, that is for the part of it that distributes the funds to buy a property already foreclosed, not for the foreclosure avoidance.

Mr. FOSTER. Okay.

The CHAIRMAN. Yes, of course, the foreclosure avoids pieces case by case by case. The gentleman is correct as to the formula but that goes in the distribution—of course, there is no distribution of Federal funds in the first two titles. In the last title, that is to buy up property already foreclosed and that is according to that formula. But the first part of where there is a write-down, presumably an FHA guarantee, there is no formula there. It is on a case-by-case basis.

The gentlewoman from Minnesota? You are the last questioner.

Mrs. BACHMANN. Thank you, Mr. Chairman. And I thank the panel members who are here as well. I wish I could have been here for all of your testimony today, but I do have a question for you. You may be familiar with today's edition of the New York Times and the headline that read, "Looming Deficit Impedes Federal Housing Agency." I would like to read two quotes from the New York Times article from this morning. The article said, "Housing officials say the agency will face a deficit for the first time in its 74 year history starting in the fiscal year that begins in October of this year. They blame the seller-financed downpayment loan program, which has suffered from high delinquency and foreclosure rates in recent years." And as I went on to read the article, it is stunning, the level of the delinquency under this program.

Here is a second quote from the article: "The program continues without any changes. Congressional officials say the FHA would face a $1.4 billion shortfall in fiscal 2009. This would mean that Congress and American taxpayers would have to subsidize the FHA for the very first time." I am concerned and I am wondering whether you are concerned that this proposal that we are now considering today will only add to or lead to this scenario? We are in a weakened condition now, and I am a little nervous that a bill of this magnitude would only add to this scenario. I would be happy to hear from any of you, particularly Mr. Montgomery.

Mr. MONTGOMERY. Thank you, Congresswoman. I have a very simple solution, and that is to just eliminate seller-funded downpayment assistance. If our portfolio was 100 percent seller-financed downpayment assistance, we would not be in business. And everybody has heard my opinion so I will probably defer to someone else but that would be a simple solution. We are their only customer by the way. No one else will accept it.

Mrs. BACHMANN. And as I understand it, the Senate has that provision included in their bill, is that right?

Mr. MONTGOMERY. That is correct.

Mrs. BACHMANN. But the House does not?

Mr. MONTGOMERY. That is correct.

Mrs. BACHMANN. Okay, is there any other comment on that?

Ms. BAIR. Well, I think Chairman Frank's proposal, especially with the 15 percent cushion for FHA, does provide additional protection in terms of this particular program. I think the chairman is making real efforts to build in some safeguards to protect the government from future losses. There may be some other areas that can be adjusted, but I think that there are some protections built into this proposal.

Mrs. BACHMANN. Anyone else? It is a concern of mine because it seems that there is a tendency to have the American taxpayer be the insurer of last resort, the banker of last resort, and we saw recently, and this is unrelated to the Federal Reserve, in their move putting essentially $29 billion worth of taxpayer money on the hook regarding the Bear Stearns, JP Morgan, Chase contract arrangement that was made and that was unprecedented. That was the first time since 1932 that something like that had occurred. That was the first time that the Fed had exercised that power, so the U.S. taxpayer does not seem to have a lot to say about their finan-

cial position but it seems very easy to put the taxpayer in some unique positions that we have never seen before: to be banker of last resort; and to be insurer of last resort.

I am concerned that we will be setting a precedent where we can go back to the deep pocket every time there is a blip on the screen. And, again, I am not trying to say that the current situation where we are dealing with foreclosures is a blip; it is not a blip. This is very real. People are suffering, and we recognize that, but at the same time, this is a private contract, these are private contracts that were entered into by borrowers and by lenders, and so I am concerned that now we are going to be bringing the American taxpayer into a contract that they neither began nor did they ask to be invited to be a part of. Do you have any comments about that?

Mr. MONTGOMERY. Well, in some ways the loans with that type of assistance are almost a subprime product. And the IRS has moved toward eliminating, they had some concerns about the circular financial arrangement, and we tried to do the same with a proposed rule, but we did not prevail on that. And, again, I had one request and that is that the House would follow the Senate in this respect and eliminate them altogether.

Mrs. BACHMANN. Mr. Montgomery, what do you foresee for the FHA as far as solvency goes, down the road? What are you seeing? It appears that the American taxpayer will have to be bailing out the FHA.

Mr. MONTGOMERY. I have immense faith in Congress that they will finally pass FHA reform, and we can price according to risk and we will thus eliminate hopefully this problem on October 1st of this year.

Mrs. BACHMANN. Thank you.

The CHAIRMAN. I thank the panel. It has been a long day but I appreciate the candor and thoughtfulness with which you have answered questions. I do have one disclaimer: To the extent that several of the panelists paid tribute to some pieces of the bill that we have, they were basically reflecting the fact that we listened to them. So I thank them for the nice words. They were being both modest and immodest, modest in giving me credit; immodest in bragging about what they told me to do. With that, the first panel is dismissed, and I will call forth our second panel.

We will begin with Dr. Alan Blinder, a professor at Princeton, and a former Vice Chair of the Board of Governors of the Federal Reserve. Dr. Blinder?

STATEMENT OF ALAN S. BLINDER, PH.D., GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS AND PUBLIC AFFAIRS, PRINCETON UNIVERSITY

Mr. BLINDER. Thank you very much, Mr. Chairman and members of the committee, at least those of you who have had the stamina to last this long. I was thinking, as I was waiting, that I am glad I do not have a mortgage; it might have been foreclosed while I was waiting. But I have no mortgage on my property.

This is a very important piece of legislation. I am very glad to come here and testify in support of it.

The credit markets in the United States and around the world, and this is broader than the mortgage market, have now been in

turmoil since last August—at times improving a bit but then deteriorating once again. I would have to say my assessment, indeed I think almost everybody's assessment, is that the overall trend since August has been downhill, not uphill, which is most unfortunate.

Ameliorating the mortgage foreclosure problem, which is the target of this bill, will not cure all the ills that afflict the credit markets, but I think it will help. And for reasons I will elaborate in just a second, I furthermore think it is central, that is, it is not the only thing that needs to happen, it is not the magic bullet, but I think it is central. I will explain why in a second.

First, I want to note that there is another point of view, one that holds, first of all, that housing prices are too high and must be allowed to fall to their market clearing levels, and secondly, that homeowners and lenders who made foolish or irresponsible decisions should suffer the consequences of their own actions. There is a legitimacy to each of these points. However, the Social Darwinist sentiment, to which this often comes down, reminds me of what Andrew Mellon said in 1931—and which, by the way, Herbert Hoover had the good sense to reject. It is short and pithy, so I am going to quote it. (The quote is right at the top of page two of my testimony.) Mellon said in 1931: "Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system. People will work harder, live a more moral life and enterprising people will pick up the wrecks from less competent people." Well, I think we outgrew that attitude in the 1930's, but it is making a comeback in this decade.

I want to take that statement as a jumping-off point to address the very legitimate question of putting the taxpayer on the hook. This bill would, as has been said by several people, leave the taxpayer holding the bag if things go wrong. I want to point out, very importantly, that the taxpayers, or if you just broaden it slightly the citizens, who are a slightly bigger group, although if you count sales tax and every kind of tax, taxpayers include everybody, are on the hook if the economy goes into a slump. Indeed, they are on the hook already, for the economy is in a slump. If we have a severe slump, or what I fear more, a protracted period when we are simply not growing as we should be because of a broken credit mechanism, every American is on the hook for that. So it is exactly the same people. What this legislation is about, and what I think this whole effort should be about, including all the things the Federal Reserve is doing, is to make the bill, in whatever form it comes, smaller. And I think there is a good chance that this bill can contribute to that.

The first part of my testimony, which I am going to go over very, very quickly in the interest of time, lists six reasons why I think, in contradistinction to Andrew Mellon, that the government should intervene to try to make this problem smaller. I will really touch on only two of them in the time allotted to me here at the witness table.

If I could call your attention to the inverted pyramid that I sketched, not that well, on page three; this looked better when it came from my secretary, but then I fiddled around with the document and made a mess, so I am sorry. The bottom of this pyramid

shows homes and then mortgages. The point I am making in this diagram is that the problems in the housing market, which of course immediately become problems in the mortgage market, sit at the bottom, at the apex of this triangle. And lots of financial instruments are then built above mortgages, so the most obvious is mortgage-backed securities, MBS. Then you have the notorious CDOs and an entire alphabet soup of all kinds of other things. And then at the top of this diagram, it shows in large letters the entire credit market, which has by now been infected by the contagion. So the problem spiraled up from the bottom in this diagram, from falling housing prices to more actual and feared defaults on mortgages, to lower values for MBS, to decimated values for a variety of derivatives built on them, and hence to the whole credit market.

The basis of the Federal Reserve's much applauded, although in some quarters criticized, intervention in the Bear Stearn's, J.P. Morgan matter was exactly stopping contagion. The Federal Reserve really did not care about Bear Stearns per se, but it cared a great deal about contagion to the rest of the financial system and thus to the entire economy. That is what this effort is about, as I see it. There has been tremendous contagion already from the bottom of this pyramid filtering up and that is why it is appropriate, I believe, to start at the bottom to reverse this cycle and turn it into a cycle where the foreclosure problem starts looking smaller rather than larger, the mortgage-backed securities start gaining value rather than losing value, and so on up the pyramid. Then you start creating more confidence in the entire credit system.

The second point I want to make, which is very much related to that, is that all modern economies run on credit and when the credit system malfunctions, the whole economy malfunctions. That takes us back to the question I raised earlier about who is on the hook for all this? Every single American is on the hook for this, and the worse the economy gets, the worse it is for all of us, Andrew Mellon notwithstanding. While the moral hazard problem is perfectly valid, this could be a very expensive moral hazard problem to solve if we just let laissez-faire do it. Laissez-faire will do it in rough but reliable ways, and, by the way, it seems to be taking a long time. That is why I emphasized that this crisis started in August, and here we are in April and the credit markets are looking worse, not better—which to me was a huge surprise. I would not have thought in August that we would still be in crisis in April.

So I just want to pick out a few points in the legislation and mention them. How many minutes do I have left?

The CHAIRMAN. About 2 or 3 minutes.

Mr. BLINDER. Two or three, alright, I will be very selective. First of all, one of the keys to the moral hazard problem is the haircuts that both borrowers and lenders will have to take. Borrowers in this bill give up certain privileges of price appreciation. I would actually like to see them give up more privileges in terms, for example, of the ability to take out a second mortgage, which includes a home equity loan, on the property. Ordinary homeowners have that privilege as long as the bank will give them the money. For these special mortgages, I think it would be appropriate to take that

privilege away as another way of controlling the moral hazard and controlling the demand for the program, as well.

When it comes to the lenders, the right thing to do, of course, is to mark the mortgages down to market. The problem, the catch here, and it is a gigantic catch, is that the market for re-selling these mortgages has practically evaporated. I would like to see the bill—and I think it is the intent, it is your intent, Mr. Chairman and the intent of other people who have input into this bill—to try to mimic something like what the market would do if the market was functioning. My idea on this was a little bit different. It was to have the FHA post buying prices for mortgages of various qualities, based on the best guess it could make of what the market price would be, and then watch. If it gets flooded with servicers trying to sell mortgages, it has set the prices too high. If nobody shows up, that will show it has made the prices too low and try to iterate in that way towards market prices. But, really, the point I want to make is that in this respect, trying to mimic what the market would do if there was a market is an important way to think about framing the legislation.

I had a number of things in here about eligibility criteria, which is going to go to determine the size of the pool of mortgages that get refinanced this way, but let me skip most of that and just make two points. One is that nobody knows how many mortgages will need this treatment, so to speak, so nobody can sit here and say, well, this will be 1 million mortgages or 1.5 million mortgages, and I think the Congress needs to allow in the legislation flexibility and just understand in Members' own minds and in citizens' minds that nobody really knows what the scale of this operation must be, and once we embark on it, it would be foolish to cut it short before it has done what it was supposed to do.

The other point I wanted to make, because it came up in the previous panel more than once, I think, is that we ought to be pretty tough about fraud, that is, people who committed fraud and misrepresentation to get their original mortgages ought not to be eligible for this program. I would like to see this program administered as a high-document one, in contradistinction to the low-document or no-document mortgages, including such things as proof of residency and a whole variety of other things.

[Gavel]

Mr. BLINDER. Am I out of time?

The CHAIRMAN. Yes.

Mr. BLINDER. Then I will stop, thank you.

[The prepared statement of Dr. Blinder can be found on page 114 of the appendix.]

The CHAIRMAN. We will get to some of this in the questions. I gave you a little extra time because these three witnesses were very forbearing for a long morning and into the afternoon.

Mr. Brian Wesbury, the chief economist at First Trust Advisors. Mr. Wesbury?

STATEMENT OF BRIAN WESBURY, CHIEF ECONOMIST, FIRST TRUST ADVISORS L.P.

Mr. WESBURY. Thank you, Mr. Chairman. Thank you, members. It is good to be here. Thank you for inviting me. I will try to be

brief but if I could put my entire testimony into the record, that would be great.

The CHAIRMAN. Yes.

Mr. WESBURY. It is interesting that Dr. Blinder brings up Andrew Mellon's quote to "liquidate, liquidate, liquidate" because we have heard a lot of talk about the Great Depression in recent weeks and Herbert Hoover and a lot of it has been about how he sat idly by while the economy crashed, and we use his image as a kind of a dart board, I suppose, these days politically about what is going on, and I think this is just false in two ways: Number one, Herbert Hoover was extremely active in the late 1929, early 1930 period; and number two, we have done unprecedented things in the last 7 months as well, and I think there are great parallels. One of the reasons that a recession turned into the Great Depression in the 1930's, in my opinion, is because the government overdid things; they became too active. Herbert Hoover signed a tax increase in 1932, signed the Smoot Hawley Tariff Act, which raised tariffs on exports and imports, and literally shut down world trade. He increased—

The CHAIRMAN. Mr. Wesbury, we do have time, but the economic history part, if we could get to the more current stuff, that would be helpful.

Mr. WESBURY. Okay. My feeling is that the history is relevant here.

The CHAIRMAN. Alright, but it comes out of your time if that is how you want to use it.

Mr. WESBURY. And I have 5 minutes, I was going to use it in a way—

The CHAIRMAN. Go ahead.

Mr. WESBURY. Just to skip to today, we have been extremely active. The Federal Reserve has cut interest rates by 57 percent in the last 7 months; that is the fastest rate cutting we have had in 60 years. There have been hundreds of billions of dollars lent to financial institutions to help them through this period of time. FHA, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks all have had rules changes to allow not the FHA yet but to allow more lending to take place. The HOPE NOW Program has by most accounts helped almost a million homeowners restructure the terms on their loans. This is a very, very active government, and I think with a matter of time, we are going to see the impact pick up and the economy pick up as well.

Now, let me go to my next point and that is this: How did we get in this mess? Was it really about fear and greed, greed of homebuyers, greed of lenders, people taking advantage of each other, or was it about something else? And my belief is that people, human beings, do not change from spendthrifts to misers overnight. They do not go from not wanting to buy homes to wanting to buy everything in sight that has a two-by-four in it overnight. Something has to happen to create a change in their behavior, and I think what changed was that the Federal Reserve drove interest rates to 1 percent back in 2003 and held them there for too long. What this did is it drove up home prices and it made mortgages extremely cheap. Everyone thought interest rates were going to stay down low forever and, as a result, we saw a surge in activity. In fact, if you look

at almost any measure of housing activity between 2003 and 2006, it surged well above its trend, and I believe that is how we got here.

The interesting thing is that this kind of mirage in the marketplace has happened before. In the 1970's, the Federal Reserve was also too easy, it drove up oil prices, Penn Square Bank made too many oil loans, and sold participation in those loans to Continental Bank and Seafirst Bank, and all three of these banks went under. In other words, we have seen financial problems caused by this occur before and in the 1980's, we continued to grow, the economy was fine, and one of the reasons that we did continue to grow is that the government was not too active in the 1980's like it was the 1970's or in the Great Depression.

So what I would come back to, Mr. Chairman, is that I would encourage the committee to think twice and be very, very patient with the economy before interfering with the marketplace. Interfering with the marketplace, as we did in the 1930's, can often lead to even worse economic problems in the future and make our issues less tolerable.

Thank you.

[The prepared statement of Mr. Wesbury can be found on page 198 of the appendix.]

The CHAIRMAN. If you need more time, we did give Mr. Blinder more time, if you want a couple more minutes, please.

Mr. WESBURY. That is okay. Five minutes is what you gave me.

The CHAIRMAN. Finally, Allen Sinai, who is the chief global economist and president of Decision Economics, Incorporated.

STATEMENT OF ALLEN SINAI, CHIEF GLOBAL ECONOMIST, STRATEGIST AND PRESIDENT, DECISION ECONOMICS, INC.

Mr. SINAI. Thank you, Mr. Chairman. Let me summarize some major points and the context in which the proposed draft legislation fits in an array of public policy measures that need to be taken to deal with the current situation. No one measure will do it, but many will.

The U.S. economy is in recession as we speak. It has been in recession since around the turn of the year. The recession is intensifying and widening as indicated by an increasing array of monthly key economic and financial indicators. The recession, already I believe in its 4th month, cannot be short. The average length of U.S. recessions has been about 10½ months. The last two in 2001, 1990 and 1991 were 8 months each and before 1980 to 1982 and 1973 to 1975, we had 16-month recessions. This one cannot be mild. Forget GDP has the measure. It is misleading as to what is really going on where it counts, in jobs, for the consumer, in housing, and for small businesses on Main Street. The downturn is also this time, in the eyes of Wall Street, a holy terror. This is what one sees in the end and in an unwinding of a boom and asset price bubble, often in business cycles occurring in real estate, the stock market or both and not just in the United States.

Now, the pinnacles of the bust in housing—declines in housing prices and effects on credit have attached to consumption spending, currently growing at a sharply lower pace, more than 3 percentage points below its historical trend and itself now touching and caus-

ing reductions in business sales and earnings so that business cutbacks, more firing than hiring, decreased production and lower inventories and reduced capital spending are adding to the economy's downward thrust.

As for housing, where a huge overhang of inventories of unsold single multi-family homes exist relative to sales, as the recession intensifies and widens and the unemployment rate rises, the demand for housing will weaken further and the overhang of supply raised by more foreclosures in the absence of legislation like the one suggested by this committee will probably remain and home prices will keep declining. The end to the declines in housing prices cannot yet be seen therefore. The U.S. recession not only cannot be short, it could also be quite severe.

The anatomy and process of the downturn suggests that we are still its early stages, much is familiar but what is new is an overlay of a financial crunch and crisis that will prolong it. What is old is an inflationary shock of higher food, energy inflation, and that will prolong it. Sticky high inflation from also high health care inflation and a lower dollar will prevent all the stimulus that is needed and/or the rising purchasing power that typically is an automatic self-correcting mechanism in a recession to bring about their recovery. The temporary tax cut stimulus will probably provide only transient help.

The process of the downturn started in housing and a decline of activity in the aftermath of an incredible boom. The housing downturn turned into a collapse, and now I think it is a bust. And the unprecedented fall in housing prices, now down 10 percent to 16 percent from previous peaks, we are not through yet, in published measures took down the value of housing as asset collateral, upon which has been built and leveraged so much credit, debt, spending, businesses, new financial instruments and the business of financial intermediaries, bank and non-bank. The ongoing credit and balance sheet crunch has cracked the U.S. financial system and made financial intermediaries the lever risk in a hurry, unwilling to lend much within and outside of the financial system. All Americans are adversely effected by this.

Housing is in crisis. There is also a financial crisis. And so one should ask, what is the role of public policy in this situation? Well, since housing is at the very heart of this episode, a place to start is with policies that seek to reduce the excess overhang of the housing stock relative to housing demand and the excess bad collateral built on the now collapsed housing sector and falling housing prices and excess supply of mortgage debt and mortgage-based, a derivative securities and structured finance built on that.

What are the policy choices? Certainly, one that has been taken and is absolutely necessary is low interest rates. These must be maintained and reduced even more. In some fundamental sense, low interest rates under normal circumstances can stop the declines of housing prices that are taking down the value of housing as collateral and as a source of ultimate value in so many derivative financial instruments and for those financial institutions whose balance sheets and businesses are tied to it and where those businesses are declining. But with the negative price dynamic of a bursting asset price bubble, the psychology associated with declin-

ing house price expectations could well overwhelm the fundamental health that lower interest rates provide; they may not work.

The second choice line of defense is an aggregated fiscal policy measure, such as tax cuts or increased government spending. The fiscal policy stimulus recently passed provides one time tax reductions to households and businesses that may cushion the overall economy from the consequences of the housing downturn for a time, but they cannot get at the root cause of the housing and financial crises: too much available housing, too little demand, too large a supply of mortgage debt, mortgage-derivative securities and structured investment vehicles relative to the demand. And, unfortunately, these tax reductions, since they are only temporary, on our work are not going to make a big difference for a very long time in the economy.

Third, there are measures in public policy that can be taken. The Federal bank central bank have done a number of these. And, of course, the fourth choice is to do nothing. Politically this is virtually impossible in the current situation. For many Americans, owning a home is a lifetime dream and the value of their house is much, if not all, the family net worth and what is needed for retirement. With so many abuses and so much laxity in supervision over what went on in housing, housing finance subprime lending and borrowing and the huge payouts to executives and workers in many financial intermediaries, the taxpaying public is justifiably enraged and concerned about what we call moral hazard.

The CHAIRMAN. Mr. Sinai, we have to move to a close.

Mr. SINAI. Doing nothing, however, would be too little and that is part of the 1930's history, public policy is here and free markets can solve many problems but there is a legitimate role for government intervention when there are market failures and casualties of capitalism.

The public policy measure being considered here is a good one. This potential legislation that would enhance the FHA to help stabilize housing, and facilitate homeownership would work through the forces of demand and supply and help to arrest the decline in housing prices. It makes lenders better off by not having to deal with foreclosure costs or the refusal or failure of borrowers to make monthly payments. It saves a lot of litigation and legal costs. Many homeowners would keep their homes; the FHA-approved lender would take the loan, reconfigure it, restructure it, and refinance it in a reasonable fashion, and it would be insured or guaranteed at little risk to the government. This enhanced program provides benefits to all, some penalties to all, retires some of the supply of mortgage debt that needs to be taken off books or mortgage-backed securities relative to demand, and should strengthen the demand for housing relative to supply.

In conclusion, as one approach of Federal Government action to intervene and cushion in this particular situation where housing has been a big source of our problems, my conclusion is Congress should move this proposal ahead, integrate Administration comments and other ideas into it, fine tune it and get it passed in a hurry, quickly, quickly, quickly. Time is of the essence.

[The prepared statement of Dr. Sinai can be found on page 185 of the appendix.]

The CHAIRMAN. Thank you, Mr. Sinai. Let me begin by saying that obviously, I am in agreement, and I appreciate two of our economist members of this panel stressing that we are dealing here with the macroeconomic problem, not just the specific problem of mortgages. I understand a lot of the criticisms, and if it were not for the fact that we have lost 230,000 jobs this year, that we are in a recession that I believe was exacerbated, there was no factor that was more of a cause of this problem than the subprime crisis reverberations. The argument for moving here is the broader economic effect. The foreclosure damage occurs in concentric circles. The main burden falls on the person whose house is lost and in some cases, they made mistakes. In an ideal world, we would let those individuals bear the burden of their own mistakes, but the other people who own houses on the block are hurt, the city is hurt, and the whole economy is hurt, so that is the justification.

One other issue I just wanted to note, the President issued a statement today about, and of course Commissioner Montgomery's testimony made clear, we have moved closer in some ways here. There was one statement in which the President says, "The Administration opposes legislation that would allow lenders or services to sell bad loans to the taxpayers through an auction process, clearinghouse, or other wholesale mechanism." That is a straw man; no such legislation is before us. The proposal today, at the encouragement of the Federal Reserve, does include an auction process but at no point will the FHA be compelled to accept any of those loans. The FHA screening procedures will remain in effect and an auction process we believe will help set a price, but before any guarantee is attached to any loan, the FHA will do an individual analysis and we will accept it or reject it, so we agree with that.

Mr. Wesbury, I was just interested that you questioned a number of things that the government has already done, and I appreciate that, but as I read your testimony, it sounds like you wish they had not, or we had not. The last page of your testimony, "Government action," talking about the contemporary situation, "Government action has compounded problems faced by the U.S. economy," and particularly you note for instance that the Federal Reserve recently, the Fed's sharp cuts in interest rates over the past 7 months have probably prolonged the recovery process. And specifically, for example, Fed rate cuts are the most likely cause of a spike in oil prices from $70 in August to a recent all-time high, so you believe that in this past year, the Federal Reserve has done a lot more harm than good. You also mentioned the HOPE NOW Program. Is that also one that has done more harm than good in your judgment?

Mr. WESBURY. No, actually I think the HOPE NOW Program, because it is voluntary between borrowers and lenders, I think borrowers and lenders would have come together even without HOPE NOW to restructure many of these mortgages or restructure.

The CHAIRMAN. So it was not harmful; it was just not effective?

Mr. WESBURY. No, I am not saying it harmed but what I am getting at there is that Federal Reserve rate cuts, especially if I am a potential homebuyer today, and I think the Fed may cut interest rates again next month, why would I buy a home today, why would I do that?

The CHAIRMAN. I understand that but—

Mr. WESBURY. That is what I am talking about. And also when the Federal Reserve cut interest rates in August dramatically, starting in September and cut them dramatically, we saw a surge in gold and silver and corn and wheat and oil prices. Oil prices went from $70 to $100, and today $111 or $110 a barrel, four airlines have gone bankrupt in the last week, partly because of high energy prices. My belief is the inflation—

The CHAIRMAN. I appreciate that, the President, for example has said that it was not anything we were doing domestically that was causing oil prices to go up, that this was worldwide factors, etc., but you disagree with that. You believe that the Federal Reserve's interest rate cuts are, as you say, the most likely cause of the spike in oil prices?

Mr. WESBURY. Absolutely.

The CHAIRMAN. The other issue, I was struck by this because I must say I have also felt that the emphasis on homeownership has been overdone and there has been a lot of pride taken in increased homeownership and it has been the goal, you say in your next to last paragraph, "A widespread effort by the Federal Government to create more homeowners is one of the key causes of today's financial market problems." Would you in the last minute or so elaborate on that?

Mr. WESBURY. Sure, and I am not saying anything that Ned Gramlich, the late Ned Gramlich, the Federal Reserve Board Governor—

The CHAIRMAN. Sadly, not available, so we will have to have you say it.

Mr. WESBURY. Right or Larry Lindsey has also said the same thing, and they both chaired the Community Reinvestment Act panel or—I'm not sure of the name of it internally at the Fed, but that subcommittee of the Federal Reserve Board that enforced the Community Reinvestment Act. They both have highlighted the fact that this forced many banks and cities to issue subprime loans in lower income—

The CHAIRMAN. Oh, no, I would disagree. Larry Lindsey has said no such thing and neither did Ned Gramlich. What they were concerned about was the failure of the Federal Reserve, Mr. Gramlich was, to use the authority granted under the Homeowners' Equity Protection Act. Without objection, I will put into the record the letter from Mr. Lindsey—which he sent a couple of years ago when he had that position—in which he said, "No, the CRA caused none of these problems." He was a strong supporter of the CRA and of expanding it and said it did not lead to any unsafe or unsound practices. And Mr. Graham specifically was critical, Mr. Blinder was there, of the failure to use the Homeowners Equity Protection Act. Neither one of them blames CRA. If you have any evidence to the contrary—

Mr. WESBURY. I do.

The CHAIRMAN. —we will take it to the record, but I have Larry Lindsey's repudiation of that argument.

Mr. WESBURY. I have somewhere with me, I did not bring all this stuff with me, but Ned Gramlich gave a speech, he didn't actually give it, someone gave it in his stead in Wyoming last year for the

Kansas City Fed in 2007 and Larry Lindsey wrote an editorial for the Wall Street Journal, both of which said the Community Reinvestment Act was part of the problem with subprime loans.

The CHAIRMAN. Well, again, Mr. Lindsey contradicted that earlier when he was on the Board. And the problem also, Mr. Gramlich was talking very much about was the Homeowner's Equity Protection Act and the insufficient regulation. I will be glad to have that testimony. I will put in Mr. Lindsey's letter that he submitted to this committee specifically on that issue.

The gentleman from Texas?

Mr. HENSARLING. Thank you, Mr. Chairman. Again, we have many important policy decisions to make here. It is always useful to have the facts. I believe that Dr. Sinai, in your testimony, you spoke of the unprecedented fall in the value of real estate that we have seen recently. But preceding that, have we not seen an unprecedented increase in the value of real estate in, at least at the moment taking a snapshot, aren't home values on a nationwide basis roughly where they were 3 years ago?

Mr. SINAI. The answer is yes. The unprecedented decline is in the published indices from 10 to 16 percent, depending on the index, relative to the previous peak. And in Table 1 at the back of my testimony, the price increases are shown and they were much, much higher than that. So, there are two ways to look at that. I think we are going to lose a lot of those extraordinary boom and bubble price increases that we had, and at the moment, we are in the process of the declines and that is really what we have to deal with unfortunately.

Mr. HENSARLING. Listening to the debate surrounding these issues, I suppose there are two compelling reasons to have Federal Government intervention, particularly taxpayer exposure to the housing market. One is we have a lot of innocent victims out there and it is the fair and right thing to do to give them Federal assistance, which ultimately is taxpayer exposure.

The other argument is we have such a precarious macroeconomic mess that even though these people may not be deserving of help, that we have to do it for the greater good of the economy. Let me first explore what is typically called the fairness argument, one we hear frequently in Congress. Again, as I look at the universe of people who may be helped by legislation, either what the chairman has put forth or similar pieces of legislation, I do not, one, conceptually believe you can help borrowers without simultaneously helping the lenders.

I fundamentally think it is an impossible task, so therefore I am sitting here wondering, we have a lot of smart people on Wall Street who supposedly knew a lot about real estate, and maybe they didn't know a whole lot about real estate. And so, at least under this piece of legislation as I understand it, potentially we are allowing those people to unload their worst performing assets for 15 percent haircuts so it is kind of a stop loss.

When I look at the borrowers' side, there is no doubt in my mind that some people were taken advantage of. Some people were victimized by what is often called predatory lending. I think it is probably basic fraud. But for every utterance we hear of the phrase

"predatory lending," we rarely hear the phrase "predatory borrowing."

In an earlier panel, I don't have it with me now, I had a copy of a FinCEN report, which I think comes about as close to an expert in Federal Government in financial crimes, that talks about a huge spike in the last 4 years of mortgage fraud, much of that being borrowers. Apparently my reading of the report is well over half of the borrowers who have either given false asset statements, liability statements, income statements, occupancy statements. So we have a whole group of these people who don't seemingly make a very sympathetic poster child for taxpayer exposure and help.

I also cited a Boston Fed report that came across my desk a few days ago that seemingly makes the case that the real reason for default on subprime mortgages isn't necessarily the inability of people to make the reset payment. Instead, it has to do with the devaluation of the asset. In other words, these were people seemingly arguably counting on the appreciation of the real estate so they could flip it or they could refinance with the additional equity, or they use the additional equity to trade out of the 6-year old station wagon into the Lexus, or get the big screen television. They also don't seem to be a very sympathetic figure.

So, again, if I am sitting here thinking am I going to reward all these people, again, it suggests to me the moral hazard issue, and ultimately, I guess I am mixing metaphors here, kicking the housing bubble down the road. And I see I am almost out of time, so that is the only question I have, starting with you, Mr. Wesbury, if you would comment.

Mr. WESBURY. Sure. I believe that one of the things that happened in that 2003 to 2006 period is that extremely easy Federal Reserve policy caused borrowers, lenders, and everyone involved in the whole process of making mortgages and packaging them up to believe that interest rates would stay low forever and that housing prices would rise forever.

By the way, Penn Square Bank believed this about oil back in the late 1970's, early 1980's; they thought oil was never going to go down so they made loans like crazy and then sold off their participations. This has happened before. And the way that these markets correct is when prices fall and the loans go bad, people pay for their bad decisions.

What is interesting is that in the last few years of this process, a lot of these loans were made with no money down. So you can sort of kind of think of a bank not as a mortgage holder but as a landlord because the homeowner had no skin in the game. With no money down, there was no skin in the game, and therefore what everybody hoped was that the price of the home would appreciate, then the homeowner would accumulate in the skin in the game.

But what happens is, if prices don't keep going up, then no, there's no skin in the game and people walk away from their mortgages. I think trying to lock people into those mortgages is a moral hazard situation that could actually make this problem worse down the road.

Mr. BLINDER. Did you want each of us to answer that?

The CHAIRMAN. Very quickly. We only have time for one more.

Mr. BLINDER. Yes, I think that there isn't any doubt that if you try to classify people as to who is morally deserving and who is not morally deserving, first of all, it is virtually impossible to do. There are certainly cases of the sort that you are talking about—no doubt. There were huge numbers who were duped into mortgage contracts that they didn't understand. That is plain. And my view is that when you come in with a fixed, generically and certainly in this case as well, when you come in with some kind of fix-up after a mess occurs, which is where we are right now, some people are going to be helped who ought not to be helped. I view that as the collateral damage that you pay in order to pull the economy out of the soup. That is the big picture here. There will be some of those cases.

The CHAIRMAN. Let me just ask to take 15 seconds on the CRA point. I just want to make this point. I think it is fairly clear. The disproportionate share of the mortgages that should not have been made in the subprime area were made by people not covered by CRA. Mortgage brokers are not covered by CRA. In fact, if you look at the banks, which were covered, they did a relatively better job. So the other point is that the worst records were by the mortgage brokers not covered by CRA. The gentlelady from California.

Ms. WATERS. Thank you very much. Mr. Chairman, members, and panelists, the discussion about macroeconomics is an interesting one, but I am so focused on the foreclosures all over America and the fact that I have been in several cities, including Cleveland, Ohio, and parts of California, such as the San Bernardino, Riverside area, and in Detroit, Michigan, where I have seen entire blocks boarded-up that I am singularly focused on helping American citizens who are in trouble. Those people that we can save from foreclosure, we need to do it and we need to do it quickly. And for those people who have been harmed by foreclosure, we need to find ways by which we can help them also.

You mentioned government's involvement and you talked about the HOPE NOW Alliance, Mr. Wesbury, and you mentioned how many modifications or workouts they have done. How do you know how many they have done?

Mr. WESBURY. It was in the testimony of Mr. Montgomery in the panel before us. He talked about it, and this has fallen pretty much in the public record.

Ms. WATERS. Well, let me just say this. One of the problems I have with trying to do oversight is the fact that we have to depend on information from regulators and those who are managing some of our agencies that should know information when they come before us. There is nobody that I have talked to who can document the number of workouts that have been done by the HOPE NOW Alliance.

As a matter of fact, there are those who have information to say they haven't done very well at all. It is indicated that HOPE NOW states that it helped 545,000 homeowners in the last half of 2007, but 33 percent more homeowners actually lost their homes to foreclosure during the same time period. In addition, through January of this year, HOPE NOW servicers have been allowed to reduce interest rates or to otherwise modify loans that are unaffordable. Instead, 72 percent of the homeowners being helped by HOPE NOW

are only receiving repayment plans. I share that information with you because the industry has had time to show what it could do.

But is the HOPE NOW Alliance or Wall Street or servicers that had time to show that they could straighten out this situation; that they could do loan modifications; that they could do voluntary things. It has not worked. It has not been done. The people do have some reasonable expectation that their government is supposed to have regulation and regulators who at least watch closely enough to know when citizens are being ripped off; when products are being invented that are misleading; and when citizens will be harmed. And, thus, when the regulators are not doing their job, and we are not doing our jobs, and the people are harmed, I think it is reasonable for them to expect some government intervention. Don't you?

Mr. WESBURY. Well, I think that there are always unintended consequences to government intervention and that is what I try to remind people of all the time, and that is if we are to bail out people today who made bad decisions, who thought housing prices were going to go up forever, what is next? Are we going to help out because their stock portfolios fall? Are we going to do this the next time, the next time housing prices are running, are we going to—

Ms. WATERS. My question—

Mr. WESBURY. —tell me people, no, don't buy a house because if you get in trouble—

Ms. WATERS. —my question is, we have a problem; we have a crisis; we have a subprime meltdown. Do you think people should have reasonable expectations that their government will do something to help them now?

Mr. WESBURY. I listed all of these things. We can go back and talk about them. The Federal Reserve has cut interest rates dramatically.

Ms. WATERS. Do you think that—

Mr. WESBURY. We have a rebate check coming starting in May. The Federal Government has been extremely active. I mean, this has been amazing. Hundreds of billions of dollars, the Federal Reserve doing unprecedented things to shore up the mortgage market. I mean, I think the Federal Government has done something.

Ms. WATERS. Do you think that there is a crisis that still remains?

Mr. WESBURY. I mean, are we out of the woods in terms of the economy?

Ms. WATERS. No, I mean, you can claim it any way you want. My question is, do you think we still have a subprime crisis?

Mr. WESBURY. I'm not sure what—I don't even—I am not trying to be—

Ms. WATERS. Okay, that is okay.

Mr. WESBURY. —combative.

Ms. WATERS. If you don't know what it is, I will understand that. If you don't know what a subprime crisis is, if you don't think that what we are confronted with now is a crisis, okay, that is fine. And if you don't think that the government should intervene, would you tell me again what the citizens of this country who depended on the regulators that are paid for by the people to give them some measure of protection, what do you think they should do? Should

they just suffer until, I think as you described, there is a natural turn and a change of things that will straighten this out; is that what you are saying?

Mr. WESBURY. No, I guess what I am saying, Congresswoman, is this, and that is that is that I believe a lot of people went into the housing market with their eyes wide open. In many cases, in these no-document loans, people were lying about their income. They knew they were lying.

Ms. WATERS. So you think that if they—do you think the regulators should have vetted no-doc loans and do you think there should have been some regulation and oversight on no-doc loans?

Mr. WESBURY. Yes, there should and there is regulation on that. One of the interesting things that the chairman said about CRA was that it did not cover the mortgage lenders. That is true, but subprime loans, when they were packaged into pools and then purchased by banks, counted towards CRA rules. So, in fact, even the mortgage lenders were influenced by the CRA program.

Ms. WATERS. Well, I think there is just a difference of opinion about who caused this mess, and if you are trying to lay off a significant responsibility to CRA for the mess, we don't believe that, most of us on this side of the aisle, just don't believe that. All right. My time is up so I would like to engage with you, but it would not be fair so I am going to go on to the gentlelady from New York. Thank you.

Mrs. MALONEY. I thank the gentlelady for yielding. Dr. Blinder, you say that the most urgent problem before us is the potential tsunami of home foreclosures, as you put it. I agree with you, and I am pleased to see that you support Chairman Frank's proposal to provide $300 billion in FHA home loan guarantees. Fed Chairman Bernanke testified before the Joint Economic Committee last week, and when we asked his opinion of this approach, he said, "I am still focused on the loan by loan approach where servicers would voluntarily modify loans to make them eligible for FHA refinancing." Given that the evidence is that this is not working, don't we need a new, large scale-strategy like the Frank proposal for this new large-scale challenge that we confront? Dr. Blinder.

Mr. BLINDER. Well, I obviously think that we do need that. The numbers here are tremendous, and as I said, and as you just said, they are in some sense at the apex of our broader credit and economic problem. What I would say, however, is that those pieces of Chairman Bernanke's testimony that you just cited seem to me quite consistent with the approach in this bill. It is voluntary. Nobody is going to be dragged into this against their will. And in large measure, it is loan by loan. There is this title, too. But in substantial measure it is, in fact, loan by loan. It is not saying that we are going to take this entire category of loans and apply a cookie-cutter treatment in which all loans are going to be treated exactly the same. So at bedrock, this is a loan-by-loan approach, although one that has enough financing behind it and enough scale behind it that you could start getting into the millions of loan refinancings.

Mrs. MALONEY. In February, Dr. Blinder, in your writings, you argued that we should bring back the Home Owners Loan Corporation, the Depression-era entity that functioned as a big bank and

bought up old mortgages and issued new more affordable mortgages. But the Frank proposal, which you now support, is for the government to be an insurer of new mortgages instead of being a bank like the old HOLC.

Since the effects would be much the same, doesn't it seem more prudent to limit government liability by being the insurer rather than the bank? And further, some have argued that we should not be putting taxpayers' dollars at risk this way, however, the Fed put taxpayers' dollars at risk to rescue Wall Street with the Bear Stearns deal, arguing that it was too big to fail. Isn't the prospect of letting millions of main street homeowners fail also too risky for our economy, Dr. Blinder?

Mr. BLINDER. Yes, let me take them backwards, starting with the one you just asked, and the answer is absolutely yes. I mean, we are looking at a very serious economic situation here. The center of the problem, as I said, is with housing, and the center of that is with foreclosures. I don't think we can afford the risk of saying, well, it may be another 2, 3, or 4 million houses that are foreclosed, but let's just let it happen because there is a bigger economy at stake. If it gets to 4 million houses, that is 4 million families. There are over 100 million families in America, and everybody has a stake in the overall economy.

On your question about the HOLC versus the insurance approach, as I say in the testimony, and as you just said, you get to a similar place by either having the government come in as a big banker or having the government come in as a big insurer. You get a lot of mortgages refinanced to more affordable mortgages, and ultimately, the taxpayers are holding the bag.

Mrs. MALONEY. One way the Frank plan seeks to recoup some of the cost of this program is for homeowners to relinquish some of the price appreciation of their homes as long as they have an FHA guaranteed mortgage. You would go a step further and limit beneficiaries. Beneficiaries should have to forfeit second mortgages and home equity loans. Are there other measure we should be considering that will help recoup the Federal costs?

Mr. BLINDER. To help recoup the costs—one thing I was going to say takes me back to your previous question. One reason I actually preferred the HOLC approach, which is not going to happen and therefore I am very happy to support this approach, but one reason I did is there was a considerable up-side potential for the taxpayer in return for taking the risk. The HOLC in the 1930's, under pretty adverse circumstances, actually turned a profit. No one could guarantee that would happen again, but it did have that aspect.

So I think the prospects, you know, the up-side participation of the government is quite limited. I think it could be bigger, by the way. I mean, it phases down and I don't think it would be a bad thing if it was greater. It is, after all, a legitimate question being asked by a lot of Americans and it came up in this hearing, especially in the previous panel, why should we be paying for this; and the more that we can explain to the people who didn't do the wrong thing, shall I say worked hard and played by the rules, that we are not making such an attractive proposition for the people in trouble. We are just trying to keep them above water and that they have

to pay for this privilege, I think the more saleable the proposal becomes.

Mrs. MALONEY. I understand.

The CHAIRMAN. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman. I just want to ask one question that I hope never happens, but I guess we have to consider the potential that it could. I am looking at a chart that was prepared by OFHEO and I actually started to pay attention to this yesterday when I watched the news and they ran a chart that was similar to this that suggested that home prices from 1975 up through 2007 increased double, more than double, but that most of that increase in value or prices was between 2000 and 2007, in fact, probably 90 percent of it. Suppose—since Mr. Frank's proposal talks about the FHA insuring this program applying to loans to new mortgages based on 90 percent of the current appraised value, you have some play in there because you have 90 percent, but you are talking about doing it on the basis of current appraised value—suppose housing prices keep going down.

What would be the—first of all, what is your assessment of the likelihood of that, and what would be the consequences of it, Mr. Blinder and Dr. Sinai? I will start will Dr. Sinai, since he raised his hand first.

Mr. SINAI. I think from my comments, you can tell that I think housing prices are going down a lot more. It is an asset price bubble that is bursting. And what we have seen when that happens is a small part of where we eventually go, point number one.

Point number two, the new mortgages would, over time, end up underwater and then it would cost the government money because of the insured nature of the draft legislation.

Number three, how much money will it cost the government compared with the lost tax receipts if nothing is done in a macroeconomy that gets worse because nothing was done? And, indeed, how much is the cost actually of this draft legislation now? It is simply the risk of the insurance. So I think you would have to think about the ultimate magnitude of a negative scenario to get comfortable with the scenario that you are talking about.

Mr. WATT. So you are saying my reference point should be not this chart that I am looking at but the prospect that nothing is done and housing prices continue to go down.

Mr. SINAI. You know, taxpayer monies are already out. The economy is a lot worse. Tax receipts are down at the Federal, State, and local government by a lot. Taxpayers are paying now. The cost of this draft legislation administratively, I think it was what, $350 million?

Mr. WATT. Let me let Dr. Blinder, and I want to get Mr. Wesbury's—I don't want him to feel left out because I would like to get his opinion on it, too.

Mr. BLINDER. The straightforward answer to your question is yes. So I took the question to be, is there residual risk to the FHA, or whatever the institution is called, if home prices continue to plummet, and the answer is yes. Now I want to qualify that with two things in addition to everything Dr. Sinai just said. First of all, it is not the case that every mortgage that goes underwater in that sense defaults. Most people want to stay in their homes and, as

long as they can keep current on the mortgage payment, they will. So it is not like, even if housing prices fall another 10 percent we shouldn't think that these mortgages—

Mr. WATT. Right, okay.

Mr. BLINDER. —new mortgages are going start defaulting in massive amounts. But maybe the more important point is how much housing prices will eventually fall and I don't know the answer to that. It will depend on a lot of things, but among those things are the actions that either Congress does take or does not take. And one of the subtexts of this legislation and other things that are going on, what the Federal Reserve is doing for example, is to try to put some sort of cushion under this decline so that we don't just fall right off a cliff.

Mr. WATT. Mr. Wesbury, quickly.

Mr. WESBURY. Sure. I look at the Case-Shiller home price index. In 1996, it was 80. It had risen to 190 in 2007, so more than a doubling in home prices. Sixty percent of that move—

Mr. WATT. You are describing the same thing I described. I am trying to get a response to—

Mr. WESBURY. —right, and I promise you I am getting to that. Sixty percent of that move was between 2001 and 2005 and 2006 when housing prices peaked. And that is when we had most of the subprime loans. We have fallen back to 2005, which means that the homes that are underwater today are the most recent mortgages, which many of them are subprime, which many of them have very low downpayments; in fact, many have no downpayments at all. Those are the kinds of mortgages that would be refinanced in this FHA proposal, I believe, and they are very vulnerable to further declines in home prices, especially because many of those are in high price appreciation areas like, let's say, Las Vegas or Florida or Southern California where we had very rapid price appreciation, lots of new home buying, and lots of exotic mortgages. I think that is where you are going to see most of the problem and that is where you are going to see most of the price decline as well. So I do think that the government becomes more vulnerable to price declines under this program because of that very reason.

Mr. WATT. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLEAVER. Thank you, Mr. Chairman. I just have one question for all three of you. I watched with great interest last evening an interview with Jesse Ventura about the state of affairs in America, and while I don't equate his responses with those of Ben Bernanke, I was interested in the fact that he spoke, I think very powerfully, about how in this crisis it appears as if the corporate interests are dealt with first and the people are considered secondarily. His comments struck home with me because that is what I hear at home, whether fact or fiction, that is a growing belief out in the world. And it is based on a number of things, the Bear Stearns bailout being one. And so when you add in the fact that in the President's budget, he either zeroed out or, in some instances, underfunded programs to aid the poor in housing, Section 8, for example, it does appear that Jesse Ventura makes a point that is being made elsewhere.

My question: Does not the chairman's proposal equal out, or at least reduce, the way in which government appears to be leaning in this crisis?

Mr. SINAI. The answer is yes. What happened is outrageous from the point of view of America and the sleepiness of the regulators that Congresswoman Waters referred to is obvious to anybody with any common sense and it is the job of government to fix those things when they happen and I think you are on the right track and you are up to doing that, and that proposal is in that spirit.

Mr. BLINDER. I also think the answer is yes. I was advocating a proposal something like this, the HOLC proposal that Congresswoman Maloney mentioned before, before the Bear Stearns, J.P. Morgan transaction, but I didn't think it would get anywhere. But the asymmetry thereby created exactly what you are referring to, I think changes things in a very fundamental way. So I think it did change. I think it is unbalanced if you leave it the way it now is and I think it is both good politics, if I may say that, but also good economics to look on the other side, to the household side, which is what this bill does.

Mr. CLEAVER. Thank you. Mr. Wesbury.

Mr. WESBURY. Sure, and I would agree with Dr. Blinder that it is good politics, or at least it looks that way, but I think it is lousy economics. And one of the reasons that I say that is that imagine if the whole financial system failed, just went away; very, very few people could ever afford a home because they would have to put cash down. They couldn't borrow money to buy it. They couldn't get insurance on the home. They couldn't get mortgage insurance, not fire insurance, not any kind of insurance because it is the financial system that provides all of that and it allows people to buy little pieces of it over time and it makes a great big thing. And then it is easy to attack this great, big thing but, in fact, we couldn't live our lives as we do today without the financial system in place.

Mr. CLEAVER. But if you are sitting here in Kansas City, Missouri, and you are out here watching this huge bailout and you have just been ripped off and you are going to get a $300 check as a stimulus, don't you think you would feel like the government always leans towards the corporate level? And are you saying that is what it should do, lean toward the corporate because if the corporate folk are healthy and happy it always rains down on the less fortunate? I mean, your comment just now reminded me of the statement—I am going to try to remember the statement from Mr. Mellon—I mean, that is kind of what you just said and paraphrased.

Mr. WESBURY. It is not what I said.

Mr. CLEAVER. Okay.

Mr. WESBURY. What I said is, sure, I can see why people might think that. But what I am saying is that you could not get mortgage without the financial sector there, and so if the Federal Reserve is not—I am not saying that I agree with the bailout of Bear Stearns and what they did with J.P. Morgan, etc., etc, but in general, helping the financial sector survive a hiccup like this, or a mess like this, or a crisis like this, is absolutely essential to keep society going like it was. You can't get a mortgage without the financial sector. So the Federal Reserve's attempt to save the finan-

cial sector, if that is the way you want to put it, you can phrase it any way you want, is actually an attempt to make sure that people can continue to get mortgages down the road. So in essence, I can understand why people feel that way, but what it tells me is they are not thinking very deeply about the issues.

Mr. CLEAVER. Well, I would like to invite you to my town hall meeting Saturday and you tell them that they are not thinking deeply.

Mr. BLINDER. Congressman, could I just say one sentence? I think this bill would do a world of good for the financial system as well.

Mr. SINAI. Congressman, what you said I have to say something. I am a citizen of this country, not just an economist or somebody who comes here to testify. What you just described is what is wrong with America. The instincts of your people tell me that if you all do something about it we will get back in the track of doing what is right for America. What went on is absolutely egregious in the financial system and all the things that happened. There is no other way in a commonsense way to put it that way, and the way that your constituents are seeing is the way most Americans are seeing it. The polls say that very clearly.

The CHAIRMAN. Thank you. The gentleman from Colorado—

Mr. PERLMUTTER. Thank you, Mr. Chairman. And I appreciate the testimony—

The CHAIRMAN. —whose questioning will be greeted with great joy, since he is the last questioner.

Mr. PERLMUTTER. I appreciate the testimony from all three of you because there are parts of things that you have all said that I agree with. Mr. Wesbury, I agree with you wholeheartedly. I mean, my belief is every 20 years we go through something similar to this because people forget the lessons of the past. They believe—they get greedy. They get stupid. They believe the prices are always going up and, you know, the 1980's, you talked about Penn Square, M Bank, Continental Illinois, Silverado, with the belief that everything was going to go up. And in Colorado it was real estate, not just oil. So it isn't just the homeowners and it isn't just the lenders. It isn't just the regulators. I mean, Congress—one of the things I am angry about is the loosening of laws that kept investment banks separate from traditional banks, I mean, a lesson we learned in the Depression for goodness sakes; all based on greed.

And I would ask you three as some of the top scholars on the subject, this Nation is borrowing a lot of money as individuals and as a nation. How does that play into everything we are doing here? Let me go back to the chairman's bill before I get to waxing eloquently. Mr. Wesbury, under his bill, it is voluntary by the lender to take advantage of a carrot, which would be the FHA guarantee at 90 percent of the written down-amount. So what is wrong with that?

Mr. WESBURY. I think as long as it stays voluntary, we are okay with it. I think if we allow the FHA—it does get the government more involved, which can always—

Mr. PERLMUTTER. But we are going to get involved if we have to start helping the FDIC and we have already gotten involved when

we gave $30 billion to underwrite Bear Stearns because of these lousy mortgages. We are already in this deal; big.

Mr. WESBURY. I understand that. One thing I go back to is that I heard the chairman say that if the servicers don't voluntarily do something, then we are going to make them do something. And I am paraphrasing him. We can go back and look at the record. So I hear you when you say voluntary, but very often once we do get involved with these things, it quickly becomes involuntary.

Mr. PERLMUTTER. Okay. So then my question is this: Listening to Dr. Sinai and Dr. Blinder, you, too, have recognized we are on sort of a precipice here. My question is, if we don't do anything, if we let the market sort of work itself out, how many foreclosures are we going have, and how long is this going to take?

Mr. WESBURY. No one knows for sure, but I think the worst estimates that I have seen in foreclosures is about 2 million foreclosures and that is out of 108 million homeowners, occupied homes. I am sorry, renters or homeowners. And so that is less than 2 percent. Now that's—anybody who has their home foreclosed on them, if they actually have resources in it, skin in the game, that is a sad thing.

Mr. PERLMUTTER. And I recognize that. I have come as a bankruptcy lawyer to this, representing lenders. I have been there for that. But something 2 or 3 weeks ago ago triggered a very dramatic effort by the Federal Reserve to move over to the investment banking side because of fear that we were in trouble on these mortgage-backed securities.

Mr. WESBURY. This is very, very similar to Continental Bank, which was too big to fail. Bear Stearns had its tentacles and counterparty risks throughout the system and the Federal Reserve was worried that that would cause systemic problems. I don't know whether they were right or not. We won't ever know because it is over now. It was similar to Continental Bank.

What I will say is that we survived, the economy survived, the 2000 to 2002 stock market crash where the NASDAQ alone lost $4.5 trillion of value. No one is talking about losses even close to that, maybe 10 percent of that in the housing market over the next couple of years. So our economy can absorb these kinds of hits much more readily than many people seem to fear today. I think we are much more resilient than people believe. And that is what I would hope is that we would believe in our economy more, that it can withstand these shocks, that the bankruptcy—

Mr. PERLMUTTER. Well, and I would have agreed with you but for the dramatic action that was taken 3 weeks ago. Over a weekend, we are not in session, boom. There was a real fear that there was going to be a domino effect on Wall Street and here we are doing a voluntary effort to help some homeowners and provide lenders a guarantee. I just don't see—compared to what we did and the dramatic step that was taken 2 or 3 weeks ago, this is helpful. It is nothing like that.

Mr. WESBURY. As long as it stays voluntary, I think it is a very good thing.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

The CHAIRMAN. And let me just add that it is voluntary in two ways, and there is an error in the Administration talking about

being forced to take bad loans. It is entirely voluntary on the part of the holders of the mortgages. No one is going to be coercing them at all. The one coercion that might have happened, and I was going to vote for it but it is now a dead issue, is a bankruptcy bill. The fear of bankruptcy in the primary residence might have been suppressed. I was a sponsor of it. It is now clearly dead. So this now entirely voluntary.

On the other side, nothing we are doing statutorily will compel the FHA to accept any loan. We have talked about changing the standards. The FHA has beat us to the punch as the Commissioner acknowledged. The FHA yesterday announced that they are going to waive this requirement of no default. But they are doing away with arbitrary restrictions to go to case-by-case and the FHA will remain committed to doing a study of each loan and not accepting a loan if they don't think it can be repaid. That one is possible. They may misjudge it and under their plan if housing prices drop more precipitously than expected, yes, there is some liability there. We would hope that wouldn't be happening. But that is it. It is voluntary on the part of the servicers. The FHA has the right to say yes or no.

We do believe, and I think it is probably, as I said, the economic problem, if I remember my economics class correctly, is mainly that there are things that an individual might not do himself or herself that he or she would do if you knew that other people were doing them as well. And that may be encouraging this together could be helpful. That is what this is and, again, I want to stress on the auction, which the Federal Reserve suggested to us. The auction—there will be a Federal mechanism that will accept bundles of loans for the FHA guarantee but the FHA will then have the independent authority to examine that pool and kick out any that don't meet its standards. So there will be no coercion of the FHA on that end. I thank the panel, particularly these three panelists for staying all day, and adding a kind of perspective that was very helpful to us, and the hearing is mercifully adjourned.

[Whereupon, at 3:32 p.m., the hearing was adjourned.]

A P P E N D I X

April 9, 2008

Congressman Randy Neugebauer
Financial Services Committee Hearing
April 9, 2008

I thank Chairman Frank for calling today's hearing and appreciate the perspectives all of the witnesses bring to our discussion of the mortgage market situation.

As our Committee considers new legislation introduced by the Chairman, I think we first need to remind ourselves that 95 percent of Americans with a mortgage are making their payments in full and on time.

At the same time, we know some Americans are having difficulty meeting their mortgage obligations for a variety of reasons. I appreciate lenders' efforts to work with borrowers who want to stay in their homes, and more than a million homeowners have been helped by the Hope Now Alliance.

However, I am concerned that these new proposals we are considering go far beyond assisting Americans facing difficulties paying their current mortgage and greatly expand the role and reach of the federal government.

It is not the role of the federal government to create equity in a home. Yet the proposal we are discussing today would put the federal government in a position of determining a borrower's equity and put the taxpayers on the hook for any further declines in that borrower's equity or default. Borrowers would be eligible even if they are able to make their current mortgage payments. As home prices appreciate in the future, borrowers who sell their property after five years could retain all gains on the value, despite not meeting the obligations of their original mortgage.

While helping some refinance who truly need the assistance, this proposal would reward many who made irresponsible decisions and transfer many borrowers' risks to the taxpayers.

While markets are not always kind, they are efficient. Home equity should be determined by the marketplace, and many areas of the country are undergoing a market correction. I believe there is private capital waiting to enter these markets, but investors won't make those decisions until they believe the federal government is done intervening and creating an even better deal.

I ask my colleagues to carefully consider all the consequences of further federal government intervention. Congress shouldn't penalize Americans who are making their payments and working hard to stay in their homes. Families shouldn't have to make their mortgage payments and their neighbor's mortgage payment too.

STATEMENT FOR THE RECORD

THE HONORABLE ADAM H. PUTNAM

FINANCIAL SERVICES COMMITTEE HEARING on
USING FHA FOR HOUSING STABILIZATION AND HOMEOWNERSHIP RETENTION

APRIL 9, 2008

Mr. Chairman, Ranking Member Bachus, I am pleased to join both of you and my colleagues today to kick-off the beginning of a two-day agenda that will hear testimony regarding Chairman Frank's proposed legislation that would address mortgage foreclosures by allowing the Federal Housing Administration to provide up to $300 billion in new guarantees to help at-risk borrowers refinance into feasible mortgages. I welcome today's two panels, and look forward to their testimony.

No one will deny that homeownership is a critical part of any working family's faithful pursuit of the American dream. The collapse of the housing bubble and subsequent rise in foreclosures has not only given many mortgage holders pause, it has also spilled over into other markets, causing shockwaves from Wall Street to Main Street. While we have a responsibility to provide a sound economy for future generations, we also have a responsibility to be responsible stewards of taxpayer dollars. Any discussion of legislation that gives cause for federal government financial intervention should first and foremost encourage homeowners to take advantage of successful initiatives that are already available.

The HOPE NOW Alliance has successfully assisted over one million homeowners receive loan workouts since July 2007, according to their most recent findings. This includes 758,000 repayment plans initiated and 278,000 loan modifications. In addition, FHASecure, has assisted homeowners with high-interest, adjustable-rate mortgages through refinancing into a FHA-insured mortgage. It is estimated to date, that FHASecure has served 145,000 homeowners. Though the program has had great success, any further expansion of FHASecure deserves careful consideration and should be executed in a thoughtful and

responsible way, and make certain the FHA is not overextended. I continue to applaud the efforts of the HOPE NOW Alliance and FHASecure and encourage homeowners to utilize one of these excellent resources.

We must also ensure that we work to help those who have been hardest hit, the truly needy and innocent victims who were caught in the wrong place at the wrong time. I caution, however, to move any legislation forward that would reward those who were reckless and irresponsible at the direct expense of the overwhelming majority who have kept up with their obligations and done what is necessary to make ends meet in this challenging economic climate. In particular, those parties – lenders and borrowers – who knowingly initiated by details of their financial institution to qualify for a mortgage that would otherwise have been unavailable to them, should not be rewarded for their dishonesty

My home state of Florida has led the nation in mortgage fraud for two consecutive years – clearly not an honor to call home about. The Mortgage Asset Research Institute's report on fraudulent mortgage activity reports that FBI statistics show 46,700 mortgage fraud reports in 2007 – a 30 percent increase from 2006 and double the findings from 2000. I'd assume that homeowners in New Mexico are in agreement with homeowners in North Carolina and Kansas – they should not pay the bill for Floridians who have misrepresented their income, their employment history, falsified their tax returns or financial statements, and law abiding Floridian's feel the same about a bailout for fraudulent loans in other states too.

In addition, the National Association of Realtors recently released their annual Investment and Vacation Home Buyers Survey finding that second-home sales accounted for one-third of transactions in 2007. I hope my colleagues agree that no federal money should assist homeowners that made a bad gamble on a vacation home or failed to make a fast buck house-flipping.

Whether it's to purchase a new home or to refinance an existing mortgage, the solution is not to bailout the housing market, but to jump start it. While abusive lending by some irresponsible lenders has worked against the common goal that we share here today of providing more homeownership for hard working families across the nation, it is important to recognize that there are a vast majority of healthy relationships that currently exist between lenders and borrowers in ensuring sound and practical loans.

In closing, the right way out of the housing crunch is to get Americans purchasing homes again, but only in a manner that protects taxpayers from having to bail out speculators and scam artists, and that creates a responsible partnership between the borrower and the government – everyone should have a stake in the outcome.

Again, I welcome today's two panels and thank all of you for taking the time to share your views on such an important issue. I am confident that a common sense, bipartisan solution exists and we should pursue that with an eye toward sound, long-term homeownership goals – not an election year band-aid.

EMBARGOED UNTIL DELIVERY

STATEMENT OF

SHEILA C. BAIR
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION

on

USING FHA FOR HOUSING STABILIZATION AND HOMEOWNERSHIP RETENTION

before the

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

April 9, 2008
2128 Rayburn House Office Building

Chairman Frank, Ranking Member Bachus and members of the Committee. I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding proposals to address turmoil in the mortgage markets and stem unnecessary foreclosures. These problems are having serious and growing consequences for our economy. Unfortunately, they defy easy resolution.

The problems facing the U.S. markets are attributable to a complex set of interrelated causes. These include weakened lending standards, inadequate consumer protections, regulatory arbitrage, and speculative activity -- as well as deficient surveillance by rating agencies and inadequate due diligence by originators and investors. No single solution or "silver bullet" can address the adverse effects of these deficiencies. Resolving these issues will require a number of approaches emphasizing different solutions for the different segments of the market. Over the past year, the FDIC has sought to work closely with mortgage lenders, the securitization industry, servicers, consumer groups, other regulators and Congress to identify and correct existing barriers to solving current problems in the markets while establishing controls to guard against their reappearance in the future.

Specifically, the FDIC has aggressively advocated systematic, voluntary loan modifications to address the pervasive problem of unaffordable loans stemming from weak underwriting, particularly in the subprime market. While voluntary loan modifications have shown significant progress, at this point, it must be acknowledged that the pace has not been sufficient to achieve the scale necessary to contain broader harm to communities and our economy.

While unaffordable resets on subprime hybrid adjustable rate mortgages (ARMS) have been addressed through the Treasury-led American Securitization Forum (ASF) framework, pre-reset delinquencies and defaults have been higher than expected, primarily due to a significant deterioration in underwriting in 2006 and early 2007. In addition, unaffordable resets in the Alt-A[1] market have begun in earnest, and will continue to rise into 2009. Because of the individualized characteristics of these loans, they do not lend themselves as easily to systematic solutions. Further creativity in regulatory and legislative efforts is necessary to resolve potential large scale problems in this segment.

Beyond the benefits to borrowers and lenders, minimizing foreclosure will be important to the broader effort to stabilize global financial markets and the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes. While lower home prices may be necessary to restore U.S. housing markets to equilibrium, there is a very real risk in this situation that relying too frequently on foreclosure will only perpetuate the cycle of financial distress, risk aversion and declining home prices that we have seen in recent months. As financial market turmoil begins to have a measurable adverse effect on U.S. economic performance, it is becoming clear that foreclosure mitigation must be part of the wider effort to restore stability to our financial markets and strength to our economy.

My testimony will provide a brief update of current mortgage conditions and a description of some key principles I believe are important in evaluating solutions to the problems in the mortgage markets. I also will discuss Chairman Frank's proposal to make greater use of

[1] Alt-A loans are those made under expanded underwriting guidelines to borrowers with marginal to very good credit. Alt-A loans are riskier than prime loans due to the underwriting standards of the loans, not necessarily the credit quality of the borrowers.

the Federal Housing Administration (FHA) as a tool to improve stability in the mortgage markets. In addition, I will discuss some suggestions regarding additional approaches Congress might want to consider as it moves forward.

Current Mortgage Conditions

A combination of increasing mortgage delinquencies, tightening underwriting standards, decreasing credit availability and falling home prices is straining the nation's economy and financial system.

Mortgage delinquency and foreclosure rates continue to rise. The problems are most severe among subprime mortgages, and especially subprime ARMs. According to the Mortgage Bankers' Association's National Delinquency Survey, over 20 percent of subprime ARMs were seriously delinquent in the fourth quarter of 2007, and over 14 percent of all subprime mortgages were seriously delinquent.[2] Data available on privately securitized subprime loans also show that loans originated in 2005 or later have become seriously delinquent much more quickly than loans originated in prior years. More than 20 percent of these loans originated in 2005 and 2006 are seriously delinquent, while more than 13 percent of those originated in 2007 are in similar trouble.[3]

Although problems are most evident among subprime mortgages, credit quality is deteriorating among other types of mortgages as well. Over three percent of Alt-A loans

[2] Mortgage Bankers Association National Delinquency Survey, Fourth Quarter 2007. Seriously delinquent mortgages are defined as those 90 days or more past due or in foreclosure.
[3] FDIC calculations based upon data from LoanPerformance.

privately securitized in 2006 were seriously delinquent after one year of seasoning, up from less than one percent for loans securitized in 2005. Preliminary data indicate that the serious delinquency rate for loans securitized in 2007 may eventually be higher than for the 2006 vintage.[4] The fourth quarter MBA survey indicated that the percentage of prime mortgages that were seriously delinquent was 1.67 percent, the highest in the ten-year history of the data series.[5] As with subprime, problems in prime mortgages are more pronounced among ARMs, with 4.22 percent of prime ARMs seriously delinquent.

One result of this credit distress has been a sharp contraction in the availability of credit to mortgage borrowers. Total U.S. mortgage debt originated in the fourth quarter of 2007 was $450 billion, down 38 percent from the fourth quarter of 2006.[6] Origination volumes have fallen even more for subprime mortgages (down 90 percent in the fourth quarter compared to prior year) and Alt-A loans (down 73 percent). The most important cause of the decline in nonprime originations has been an inability to find buyers for mortgage-backed securities (MBS) backed by these loans. Total issuance of subprime MBS fell by 89 percent in the fourth quarter of 2007 compared to the prior year, while issuance of Alt-A MBS fell 86 percent.[7]

Housing market distress both contributes to and derives from these problems in the mortgage markets. An increase in foreclosed properties is contributing to a surge of homes for sale at the same time that the credit needed to purchase homes is becoming less available. Sales

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[4] FDIC calculations based upon data from LoanPerformance.
[5] Mortgage Bankers Association National Delinquency Survey, Fourth Quarter 2007.
[6] *Inside Mortgage Finance*, November 16, 2007 and February 8, 2008.
[7] *Inside MBS & ABS*, July 13, 2007 and January 11, 2008.

of existing homes peaked in mid-2005 and have fallen by more than 30 percent since then.[8] The number of vacant homes listed for sale at the end of last year was just under 2.2 million units, up 39 percent during the past two years.[9] As 2007 progressed, weak sales and vacant homes were increasingly reflected in U.S. home prices which fell at a rate not seen in at least 60 years. According to the latest data available from Standard and Poors/Case-Shiller, home prices fell 5.4 percent in the fourth quarter of 2007 and were down 8.9 percent from a year earlier -- the largest declines in the 20-year history of that series. The Case-Shiller indices also show that prices in some metropolitan areas fell by 15 to 20 percent during the twelve months ending January 2008. Steep home price declines are an important new dynamic that is driving up foreclosure rates. Falling home prices reduce homeowner equity, which then makes it more difficult to refinance or sell a home, leading to lower sales and higher delinquencies.

The rising trend of foreclosures imposes costs not only on borrowers and lenders, but also on outside parties. Foreclosure has been shown to diminish the market value of other nearby properties. Foreclosures may result in vacant homes that create an appearance of market distress and may invite crime. Distressed sales of foreclosed homes result in low "comparable values" in a neighborhood, reducing the appraised values of nearby homes. In addition, the direct costs of foreclosure include legal fees, brokers' fees, property management fees, and other holding costs that are avoided in workout scenarios. These costs can amount to up to 40 percent or more of the market value of the property.[10]

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[8] National Association of Realtors, seasonally adjusted rates.
[9] Bureau of the Census.
[10] Capone, Jr. C. A., Providing Alternatives to Mortgage Foreclosure: A Report to Congress, Washington, D.C.: United States Department of Housing and Urban Development, 1996.

Policy Responses

For the past year, the FDIC, other regulators, the mortgage industry, consumer groups and Congress have been aggressively engaged in seeking solutions to the problems in the mortgage markets. Several actions, such as issuing guidance regarding problematic loan products and rulemaking to establish national lending standards, have been focused on preventing future abuses in the mortgage industry. Other proposals have sought to address the existing problems in the mortgage markets that are threatening many borrowers with foreclosure.

With regard to preventing practices in the future that contributed to the current issues in the mortgage markets, strong final rules by the Federal Reserve Board under the Home Owners Equity Protection Act (HOEPA) that impose basic principles of sound underwriting on both bank and non-bank mortgage originators are essential. An important complement to these substantive rule provisions would be the creation by Congress of a federal entity to buttress the efforts of the states to better license and police mortgage originators. This Committee adopted a set of strong licensing provisions as part of H.R. 3915 last year. Similarly, the Treasury Department has proposed creating a Mortgage Origination Commission that, working with state authorities, would develop minimum national licensing qualifications for all mortgage market originators. Although these two approaches differ in some details, their best elements could be merged into a single proposal that would address this urgent issue and command widespread support.

I would emphasize that there is a particular urgency for Congress to act on legislation to establish national licensing standards for non-bank mortgage participants. As interest rates have

declined, advertisements are once again promising low "teaser" rates, no-documentation and no-money-down loans, as well as using the term "fixed" in potentially misleading ways to describe the interest rate on variable-rate mortgage loans. Banks are not allowed to market, originate, or fund loans with such weak underwriting, but no such restrictions apply to non-bank mortgage participants nationally. Combined with strong final FRB HOEPA rules, passage of legislation by the end of the year creating a Commission to license and police mortgage originators would help prevent these practices from again misleading borrowers and adding more problems to the mortgage markets.

In addition to preventing harmful lending practices in the future, the FDIC and our fellow regulators are working to prevent unnecessary foreclosures now. These efforts were initially focused on subprime borrowers who occupied their homes and were current on their payments, but were facing future unaffordable interest rate resets. Focusing initially on this group of borrowers made sense because of the immediacy of the risks these borrowers were facing and the potential to reach large numbers of borrowers through systematic approaches. Voluntary systematic loan modifications offered the best option for rapidly addressing the problems of a large number of borrowers.

Before loan modifications could be considered a viable alternative, however, a number of legal, tax and accounting issues needed to be addressed. The FDIC and many others in the government and the private sector laid the necessary groundwork to proceed by removing or clarifying possible barriers and permitting loan modifications to move forward.

The Treasury Department was instrumental in the formation of the ASF framework to provide a systematic approach for restructuring subprime ARM loans for owner-occupied properties where the borrowers are current on their payments but cannot afford the payments following the reset of their interest rates. Restructuring these loans into sustainable loans assists in halting housing price declines prompted by rising foreclosures and vacancies. To date however, this approach has not been fully utilized.

Another option available to as many as 240,000 borrowers is the FHA's *FHASecure* program, which provides low-cost refinancing options to good borrowers who were steered into high-cost loans with low introductory rates. Both the ASF framework and the *FHASecure* program, however, apply to distressed borrowers confronting unaffordable resets. In many cases, loan modifications to alleviate resets may not be enough to ensure loan affordability. In addition, the current *FHASecure* program guarantees loans with extremely high loan-to-value ratios, creating additional government exposure as home prices decline. As we note later in this testimony, a positive feature of Chairman Frank's proposal is the creation of a 15 percent cushion against *current* appraised value for loans to qualify under his proposal.

Loan modifications were never intended to serve as the sole solution to the problems in the mortgage markets. The intention was that a systematic approach to loan modifications would address some broad categories of borrower problems while freeing up resources to address more difficult cases. In fact, some lenders and servicers have begun to consider additional approaches. For example, consideration is being given to strategies that would forgive a portion of the principal balance to bring payments to a level that borrowers can realistically afford to repay,

while at the same time yielding net present values greater than the anticipated net recoveries that would result from foreclosure. I would hasten to add, however, that we do not advocate principal reductions except when necessary to achieve an affordable payment for the borrower. Recent changes to the tax code now allow for mortgage debt to be forgiven without any tax liability on the part of the borrower.

Principles for Solutions to the Mortgage Crisis

In the absence of adequate initiatives to assist distressed borrowers and restore secondary market liquidity, we are very concerned that a continuing cycle of default, foreclosure, home price declines, and uncertainty will occur, leading to further losses and impairing the performance of the U.S. economy. Avoiding this result will require creative approaches to addressing the problems in the industry that recognize the interests of all involved parties. With the wide range of potential options available, it is helpful to establish certain principles as guideposts to assist in the evaluation of ideas and to ensure they achieve the desired outcome. The FDIC believes that programs for resolving the residential mortgage crisis should be guided by the following fundamental principles.

- ***The proposals should result in solutions that are sustainable over the long term.*** Solutions need to result in long-term, sustainable mortgage payments that borrowers can afford to pay. Failure to do so heightens the probability that borrowers will not be able to perform under the new terms, causing them to default on the modified loan and lose their

home. Making the mortgage sustainable for an individual borrower might require a reduction in interest rates and/or principal sufficient to ensure affordability.

- ***The proposals should provide as much fairness as possible and require shared sacrifice on the part of participants.*** Any proposal that addresses the current problems in the mortgage markets is going to raise issues of fairness, especially on the part of borrowers who have remained timely on their mortgage payments. However, properly structured proposals will provide benefits beyond the immediate participants by preventing large numbers of foreclosures that would have a broader negative impact on communities and homeowners.

  Market participants who benefited most in recent years from many of the practices that have caused the current market problems, should bear a significant portion of the cost of resolving these issues. Otherwise, the result will exacerbate moral hazard and encourage irresponsible lending in the future. By the same token, borrowers who can afford to continue making their payments should do so. Qualifying standards should prevent borrowers who can afford their payments from taking inappropriate advantage of program benefits and should ensure that financial relief is provided to those homeowners who truly need it.

- ***The proposals should leverage existing market mechanisms to provide appropriate incentives and avoid delay.*** Programs should provide a systematic and streamlined process for reaching as many qualified homeowners as fast as possible. Failure to work

with struggling borrowers on a timely basis will contribute to escalating losses for investors, homeowners, and communities. In addition, existing government and market structures, entities, and programs should be used to the extent possible. This eliminates the "start up" time lost when creating new programs and takes advantage of existing expertise.

- ***The proposals should attempt to limit the government's liability for future losses.*** Lastly, it is essential that intervention minimize government and, ultimately, taxpayer exposure to losses. "Bailout programs" undermine the market discipline that is imposed when lenders, investors, speculators, and borrowers are held accountable for the risks they take. Government refinancing programs, in particular, pose the danger of adverse selection because, once the loan is refinanced out of the securitization pool, the investors bear no further risk of default. Thus, even among a universe of troubled loans, there may be economic incentives to leave to the government those mortgages least likely to perform, and retain those of higher credit quality.

FHA Housing Stabilization & Homeownership Retention Discussion Draft

Chairman Frank recently proposed a new program under the FHA to provide a voluntary mechanism to refinance troubled loans into long-term, sustainable loans. Overall, the Frank FHA proposal ("Discussion Draft") includes many positive features and addresses many of the FDIC's fundamental principles. Essentially, the proposal creates a mechanism where borrowers

can obtain affordable, FHA insured loans from new lenders that are accepted as full payment of the existing mortgages by the investors.

Traditionally, FHA provided a mechanism to permit low- and moderate-income consumers to obtain traditional, 30 year fixed rate mortgage financing to purchase homes. Low- and moderate-income lending provides the strongest public policy basis for government support of housing. In recent years, however, FHA products lost market share to private label securitizations. Traditional FHA lending was replaced, especially in subprime markets, by products of dubious design and quality that have contributed substantially to our current problems. Using FHA as the vehicle to refinance some portion of these troubled loans will return FHA to its traditional role of meeting the needs of low-and moderate-income borrowers and stabilizing housing markets.

The Discussion Draft would require that existing mortgage holders agree to accept the proceeds of the FHA insured loans as payment in full of all indebtedness and release all liens. Lenders and investors who stood to profit from these mortgages would absorb substantial losses, as they effectively would settle for 85 percent of the property's *current* appraised value in full satisfaction of the debt. While this settlement amount represents a substantial reduction for the lenders or investors, the proceeds in all likelihood would still be greater than what could be realized from foreclosure, and would protect the seller against the threat of even greater losses if properties continue to decline in value.

The Discussion Draft also would require that the new insured loans must be properly underwritten and should substantially reduce the existing senior mortgage debt. These requirements would help to ensure that the new loan is sustainable over the life of the loan. The new debt service payments must bear a fixed rate of interest for the entire term of the mortgage and can permit a total debt-to-income (DTI) ratio of up to 40 percent, based on the borrowers' documented and verified income. However, borrowers who have made six months of timely payments that equaled or exceeded the new FHA loan payment amount also would be eligible for higher debt levels. While these underwriting standards will expand the number of eligible borrowers, the FDIC notes that, absent mitigating circumstances, DTI ratios exceeding 50 percent increase the likelihood of future delinquencies or defaults.

Under the Discussion Draft, only owner-occupied residential mortgage loans originated on or after January 1, 2005 and before July 1, 2007 are eligible for consideration. Borrowers must certify that they did not intentionally default on their existing mortgage(s). In addition, borrowers' payments on all existing mortgages must exceed 40 percent of their income as of March 1, 2008. These screening parameters provide reasonable borrower qualification criteria for participation in the program and should ensure that it is targeted to borrowers most in need of assistance.

The proposal strives to protect taxpayers from losses by ensuring that borrowers have a reasonable ability to repay the loan. Despite this safeguard, some mortgages will inevitably default anyway and the FHA will be exposed to credit losses. The proposal minimizes government and, ultimately, taxpayer exposure by insuring against losses through the Special

Risk Insurance Fund, which would pay claims against these guaranteed loans. These claims payable through the Special Risk Insurance Fund would be funded by:

- Imposing a single premium payment of 5 percent of the amount of the original insured principal obligation of the mortgage;
- Assessing the borrower a 1.5 percent annual premium payment; and
- Charging an exit premium based on a sliding scale, but a minimum of 3 percent.

These premiums should create a significant reserve against losses on loans guaranteed through the new program. However, it currently is unknown whether the premiums will provide sufficient resources to fund all claims that arise from the insured loans. Losses that exceed the funds available in the reserve would have to be covered by taxpayers.

These premiums also should help prevent unjust enrichment to both borrowers and lenders or investors. The required exit premium will keep borrowers from profiting from an abrupt increase in housing prices if they sell their home or refinance their mortgage within five years of receiving the new loan. Likewise, the initial single premium payment will reduce the net proceeds that could be received by lenders or investors.

Finally, the Discussion Draft approach would make effective use of existing governmental and market structures. By modeling the proposal on existing FHA programs, the time and expense of creating the program are significantly reduced. The proposal also envisions

packaging loans into mortgage backed securities guaranteed by the Government National Mortgage Association.

In general, the Discussion Draft addresses many of the principles the FDIC considers necessary for an effective program. It converts current problematic mortgages into loans that should be sustainable over the long-term and convertible into securities. It also requires that investors accept significant discounts and prevents borrowers from being unjustly enriched if home prices appreciate. The proposal uses existing government and market structures which should permit the program to be implemented quickly. In addition, the proposal attempts to provide a financial cushion in the program to help insulate the FHA and taxpayers from losses.

Concerns

Although the Discussion Draft includes a number of positive elements, some difficult issues remain. A major difficulty in refinancing proposals for many troubled mortgages is the significant percentage of them that are subject to second liens. Resolving this issue is essential to ensuring the effectiveness of any proposal. It is not clear what incentives and processes might be necessary to obtain the agreement and participation of parties holding these second liens.

Another concern relates to the FHA's ability to contend with the potential volume of borrowers seeking participation in the program. The FDIC estimated late last year that almost 1.3 million hybrid loans were scheduled to reset in 2008 with an additional 422,000 hybrid loans

scheduled to reset in 2009.[11] The FHA endorsed (insured) over half a million single family mortgages for insurance nationwide in fiscal years 2006 and 2007.[12] Even though the proposal provides measures to enhance the FHA's capacity, the agency's resources will be significantly stretched to deal with the possible influx of applications.

A third concern pertains to the possibility of creating the unintended consequence of promoting adverse selection, even within a universe of troubled loans. Lenders and investors might retain loans to higher quality borrowers and submit only those mortgages where the borrowers owe substantially more than the property is worth and/or have demonstrated little ability and/or willingness to repay. While such loans are intended to be considered under the program, a disproportionate concentration of the lowest credit quality will obviously impact FHA loan performance and losses.

A final issue relates to the lack of financial incentive for servicers to modify loans. The governing contract documents, the pooling and servicing agreements (PSAs), generally do not provide any compensation for servicer costs associated with loan modifications. Yet the success of this proposal in achieving scale restructurings to facilitate FHA refinancing will rely heavily on servicers devoting significant resources to writing down the loans.

To address adverse selection as well as the lack of servicer incentives, we suggest that Congress consider requiring the investor to initially settle for 80 percent of the property's *current*

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[11] FDIC estimates are based on the Loan Performance Securities Database. They reflect data collected through August 2007 on first-lien mortgages secured by owner-occupied properties where the mortgage has been securitized in private MBS issues. These figures have been adjusted to include an estimate of subprime securitized loans that are not included in the Loan Performance database.

[12] *FHA Annual Management Report*, Fiscal Year 2007, pages 22-23.

appraised value in full satisfaction of the debt with an additional 5 percent being released to the servicer and investment pool in equal increments over three years *so long as the loan continues to perform*. The incentives would need to be structured to minimize the potential for conflicts of interest. For the future, we also suggest that the mortgage industry should revise the standard language in PSAs to provide reasonable compensation to servicers for loan modifications in addition to foreclosures.

Additional Suggestions

Title II of the Discussion Draft establishes an outline for an auction system to address troubled mortgages on a bulk basis. As the difficulties that homeowners and the credit markets face are growing, Congress may want to consider additional options that might achieve sufficient scale to benefit large numbers of troubled borrowers and achieve market stability. While auctions can be an effective mechanism for addressing large inventories of assets, it will be difficult to develop an efficient auction structure involving securitized assets and a fair mechanism for establishing value in the current markets.

The financial and market dislocations that have occurred thus far call for bold steps. While significant, direct government intervention into the mortgage markets should be avoided unless absolutely necessary, current circumstances may dictate that the federal government take a more direct role in facilitating solutions for many thousands of troubled mortgages to avoid more dire consequences for all Americans. The direct purchase of mortgages through an auction process, as outlined in Title II, may be one solution if the legal and valuation issues can be

resolved. However, there are other options that may help limit government and the taxpayer exposure to future losses.

As mentioned earlier, two of the key principles for crisis management in our market economy are to adopt solutions that operate within existing market mechanisms and to ensure that the ongoing risks are borne by those who stood to gain from the original investment. Since the problems today come from unaffordable mortgages and increasing numbers of homeowners who owe more than their home is worth, optimal solutions would seek to address those issues within existing market structures. Title I of the Discussion Draft is one way of achieving this, by allowing borrowers to refinance into sustainable mortgage loans using this new FHA program.

Another approach may be direct government incentives for principal pay-downs within the existing securitization trusts. Incentives to restructure the mortgages within existing pools through significant reductions in mortgage principal can achieve affordable and long-term sustainable mortgages at today's market interest rates. This can be targeted to benefit borrowers, rather than investors. Importantly, significant reductions in the current principal balance of the mortgages can create new equity for homeowners -- which, as in Title I, could be phased in over a period of years -- that will encourage community stability and reduce the proliferation of vacant homes. By keeping the restructured mortgages in the existing securitization pools, the investors -- not the government or taxpayers -- retain all of the risks of future delinquencies. That is where those risks should be. We would welcome an opportunity to explore such structures with Congress in addition to FHA-based proposals.

Conclusion

The FDIC continues to encourage servicers to work with borrowers to achieve long-term, sustainable loan modifications. This method continues to hold promise, and it would be a mistake for servicers or borrowers who could currently engage in loan modifications to delay their efforts with the hope of getting a better "deal" from Congress or the regulators. Any viable proposal is going to require that investors accept significant losses and that borrowers are evaluated according to their ability to repay.

Nevertheless, loan modifications were never intended to be the sole solution to the problems in the mortgage market. It is appropriate that policy makers carefully consider additional tools for addressing the variety of issues creating uncertainty and volatility in the markets. The FDIC supports long-term solutions characterized by fair apportioning of the costs and risks of modifying or restructuring loans, the use of existing government and market systems, and the mitigation of potential exposure to taxpayers. The FDIC is committed to working with Congress constructively to identify solutions for establishing values and transparency that will result in healthy and vibrant mortgage markets in the future.

This concludes my testimony. I would welcome any questions the Committee might have.

Intervening to Reduce Foreclosures: Why and How

Testimony of
Alan S. Blinder
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs
Princeton University
to the
House Banking Committee

April 9, 2008

Mr. Chairman, members of the Committee, I'd like to thank you for the opportunity to testify on this important piece of legislation. Our nation's credit markets have been in turmoil now since last August, at times improving for a while, but then deteriorating once again. Unfortunately, the overall trend since August has been down, not up. While ameliorating the mortgage foreclosure problem will not cure all the ills that afflict our credit markets, I believe that doing so is central. Indeed, it will be difficult to extricate ourselves from the overall financial mess without doing something major to limit foreclosures. Thus I view this bill, or some similar piece of legislation, as probably necessary but not sufficient to escape from the current financial problems.

There is, of course, another view—one that holds, first of all, that housing prices are too high and must be allowed to fall to their market-clearing levels, and second, that homeowners and lenders who made foolish or irresponsible decisions should suffer the consequences. There is some legitimacy to each point, of course. I would not favor either putting a literal floor under house prices or bailing out homeowners 100%. But the Social Darwinist sentiment reminds me of one-time Secretary of the Treasury Andrew Mellon, who gave the following (bad) advice in 1931:

Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate. It will purge the rottenness out of the system... People will work harder, live a more moral life... and enterprising people will pick up the wrecks from less competent people.

I thought we outgrew this attitude in the 1930s. It reminds me of using bleeding to cure disease.

Why Intervene?

In sharp contrast to the Mellon treatment, I believe the federal government has a duty to intervene to reduce the magnitude of the current foreclosure problem. Why?

First, there is *the human dimension*. Millions of home loans are now in or headed for foreclosure, in the biggest wave of defaults since the Great Depression. While some of these homeowners knowingly made unwise bets that ever-rising house prices would bail them out, many were victims either of their own lack of financial literacy or of dubious (if not fraudulent) lending practices. Furthermore, a massive wave of foreclosures will exacerbate many economic and social problems facing families, communities, and governments at all levels.

Second, the act of *foreclosure destroys value unnecessarily*. Think of the house and the mortgage, jointly, as representing a certain amount of value. Experts estimate that foreclosing on a property typically destroys about 30% of that joint value. But renegotiating the mortgage often can preserve most of it. Unfortunately, our modern system of mortgage finance makes such renegotiations difficult. Nowadays, the majority of mortgages have been securitized and sold to buyers who do not even know the names of the original borrowers. The resulting mortgage pools were then sliced, diced, and tranched into complex derivative instruments that no one really understood—and that were sold to investors all over the world. A mortgage workout presents one set of

problems when the borrower and the lender can sit down together to renegotiate terms. But how do you conduct a negotiation when the borrower and the lender don't even know each other? That's one reason why the renegotiation process needs a helping hand.

Third, a massive wave of foreclosures would feed the vicious cycle--depicted schematically by the inverted pyramid in Figure 1--that now runs from falling home prices, to more delinquencies and defaults on mortgages, to lower values for mortgage-backed securities (MBS), to even lower prices for related derivatives, and finally to strains in the entire financial system. By reducing the number of homes being dumped onto an already depressed market, reducing foreclosures can help limit the decline in housing prices at the base of this pyramid, and thereby improve the entire financial picture.

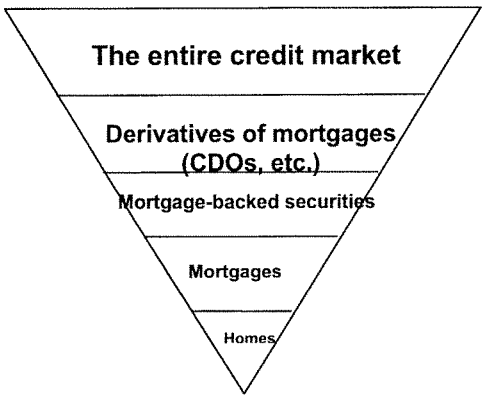

Figure 1
The Inverted Pyramid

Fourth, the *financial contagion* from the mortgage mess has been truly stunning; and it seems not even to have abated, much less stopped. Indeed, new problems keep cropping up in markets far removed from home mortgages (e.g., municipal finance). More and

more credit markets of all kinds are functioning poorly; some are not functioning at all. As I said, it seems unlikely that we can find our way out of the credit mess without first fixing the mortgage mess. While no one can know for sure, I believe that limiting foreclosures, and thereby enhancing the depressed values of MBS, stands a good chance of easing overall pressures in the credit markets—in a kind of "reverse contagion" (see again Figure 1).

Fifth, and related, for whatever reasons, private capital is not pouncing on the bountiful buying opportunities that now exist in distressed assets—at least not much. I believe that some sort of *galvanizing event*, whether from the private or public sector, stands a chance of reversing the psychology of panic that now grips the markets. Passing this bill just might be that galvanizing event. And, by the way, as private capital starts pouring in, the government should start withdrawing from the market.

Finally, and perhaps most important, because all modern economies run on credit, the malfunctioning of the credit markets *threatens the overall economy*. Mellon's stern attitude notwithstanding, it is dangerous to put the whole economy at risk in order to teach a moral hazard lesson. Were I a voting member of Congress, I would not want to run that experiment.

How to intervene

If we are not just going to liquidate, liquidate, liquidate, we need a sensible, administratively feasible, cost-efficient way to intervene to limit foreclosures—something that hopefully mimics much of what markets would do if they were functioning properly.

In a *New York Times* column in February, I advocated one possible approach: creating a modern version of the Depression-era Home Owners Loan Corporation, which bought up old mortgages and issued new, more affordable ones in their place.[1] The bill now before this committee would accomplish something very similar, but in a different way. It would use the FHA to make the federal government a big mortgage *insurer* rather than a big mortgage *lender*. But the effects would be much the same: old, unaffordable mortgages would get replaced by new, more affordable ones; and the government would assume the risk of default going forward.

In a follow-up column in *The New York Times* just a few days ago, endorsing this bill, I discussed a few of the more important aspects of The FHA Stabilization and Homeownership Retention Act.[2] Much of what follows is based on that article. Here are some of the key decisions that need to be made.

First, we need to recognize that those who oppose bailouts have legitimate arguments. The plan must not be too generous in shielding people and businesses from the consequences of their own mistakes, for at least two reasons. Economically, mistakes must be punished in order to minimize the danger of repeat performances--the moral hazard argument. Politically, we must be able to give reasonable answers to responsible citizens who ask why their tax money should be put at risk bailing out people who behaved irresponsibly and cannot pay their debts. It's a fair question. And to answer it, both lenders and borrowers must bear some losses.

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[1] Alan S. Blinder, "From the New Deal, a Way Out of a Mess," *The New York Times*, Sunday Business Section, February 24, 2008, p. 6.
[2] Alan S. Blinder, "How to Cast a Mortgage Lifeline," *The New York Times*, Sunday Business Section, March 30, 2008, p. 6. There are some minor differences between the House bill and the Senate bill. But, for current purposes, these are inconsequential

The loss to the lender depends mainly on the "haircut"—that is, the discount below face value--that is applied when old mortgages are purchased and refinanced. Conceptually, the correct haircuts would reflect current market values. That would be the truest application of the no-bailout principle and, as I understand it, is at least consistent with the intent of this legislation. But there's a big catch: With the resale market for mortgages virtually shut down, there are hardly any market prices to use for reference. This poses a knotty problem, which the draft legislation "solves" by making the haircut depend on the market value of the house and the face value of the mortgage.

My suggestion is a bit different. It is that the new FHA post *initial* buying prices for mortgages of various qualities, based on its own best estimates of what constitutes fair market value. Then it should adjust those prices according to whether mortgage owners rush in to sell (meaning that prices were set too high) or stay away (meaning that prices were set too low). In that way, the government can mimic what the market would do until a real market re-emerges.

What about the borrowers? How do we make them pay for the privilege of obtaining new FHA-guaranteed financing? The bill proposes that borrowers relinquish part of any future price appreciation on their houses for as long as these concessional mortgages remain in effect. I support that idea, but would go further by also taking away their right to take out a second mortgage or a home equity loan.

What about the scale of the mop-up operation? That's a very good question, but one without a good answer. I think 2 million mortgages is a reasonable number to be thinking about for now, but no one knows if that will be adequate to turn the tide. I think we must

be prepared to refinance more than 2 million, if necessary. Of course, if the sickness in our mortgage markets lifts quickly, the government might have to do less.

In part, the scale of the operation will be governed by the eligibility criteria. The bill is correct to limit refinancings to primary residences; second homes, vacation homes, and houses bought "on spec" should not be eligible. And the government should demand proof of residency. In addition, applicants must not have misrepresented their financial conditions, or committed any other kind of fraud, in obtaining their current mortgage—and they must provide the standard documentation (of income, assets, etc.) that was often missing in the "low doc" and no doc" mortgages of the 2005-2007 period. These new mortgages should, by contrast, be "high doc." I would also place explicit upper limits on both family income and house value. And, to hold down the number of applicants, the special refinancings will need to be limited to mortgages signed between certain dates--perhaps, from January 1, 2005 until the date on which the bill is introduced in Congress.

But all these are the easy parts. The new FHA will also have to develop sensible criteria (based on standard measures of affordability) that rule out (a) mortgages that are easily affordable without modification and (b) cases in which homeowners cannot afford even new, less onerous mortgages.

Importantly, the draft legislation recognizes the important principle that emergency measures should not outlast the emergencies they are intended to cure. To guard against this danger, the new FHA should cease granting these special mortgages after perhaps two or three years. And the mortgages it guarantees should be packaged, securitized, and sold back into the market as soon as conditions permit. Happily, the bill embodies these two ideas.

Finally, while I understand that this may come in separate legislation,[3] the government must provide legal comfort to mortgage servicers who are now worried (among other things) about the potential for lawsuits if they sell individual mortgages—which are, after all, owned by other people--"at a loss." Congress needs to pass legislation that makes it clear that servicers are *not* violating fiduciary standards, but rather are behaving in a way that is consistent with standard industry practice, when they sell mortgages below face value in a depressed market. Because servicers may also be worried about jeopardizing their tax status as REMICs (Real Estate Mortgage Investment Conduits), Congress should amend the REMIC statute to state that REMIC status is *not* lost when mortgages are sold at discounts.[4] Indeed, these steps should be taken in any event. Should such legal measures miraculously reestablish a viable market in mortgages on their own, the rest of the plan need not be promulgated.

A miscellany

Finally, and very briefly, I want to mention just a few other "details" that need to be addressed and could be important.

- *Second mortgages*: Many homes in danger of foreclosure have second mortgages or some other subordinated lien on them. If the first mortgage goes into foreclosure, these seconds will presumably become worthless. Yet their owners have legal rights that can hold up FHA refinancings. This is a difficult problem, and some reasonable way to deal with seconds must be found.
- *HUD*: Doing this job via the FHA puts the entire operation under aegis of the Department of Housing and Urban Development, which would not have been my

[3] Such as H.R. 5579, the Emergency Mortgage Loan Modification Act.
[4] A January 8, 2008 letter from the SEC's Office of Chief Accountant may suffice to accomplish this. I am not enough of a lawyer to judge.

chosen venue for such a large, complex, *financial* operation. Careful attention must therefore be paid to proper staffing and oversight.

- *Ramp-up*: Once the legislation passes, this operation needs to get going as quickly as possible. During its ramp-up period, the new FHA might want to concentrate, e.g., on subprime ARMs because they are in the most immediate peril. But that restriction should be temporary. The problem is bigger than subprime ARMs.

Last word

In sum, there are details that still need to be worked out—some in the legislation and others in the regulations and procedures that will be developed to implement the new law. This is not flawless legislation. (What bill is?) Nor, as I said earlier, is the bill a magic bullet that will cure all of our financial woes. Life is not that simple. But the FHA Stabilization and Homeownership Retention Act is a fine piece of legislation, well crafted and well targeted. And I am proud to support it enthusiastically.

Thank you, Mr. Chairman

For Release Upon Delivery
10 a.m. April 9, 2008

TESTIMONY

OF

JOHN C. DUGAN

COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

U.S. HOUSE OF REPRESENTATIVES

APRIL 9, 2008

Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent those of the President.

I. Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify today concerning the proposed FHA Housing Stabilization and Homeownership Retention Act of 2008 (Act), which Chairman Frank recently circulated for discussion. Where a distressed borrower could no longer afford his or her mortgage, the Act would establish a new program that would provide the borrower and the holder of his or her mortgage with an alternative to the costly prospect of foreclosure: if the borrower and mortgage holder agreed and the borrower met certain criteria, the mortgage holder would reduce the mortgage principal to an amount that would be affordable for the borrower; the mortgage holder would accept the corresponding loss; and the mortgage would then be refinanced into a new FHA-insured mortgage product at the lower amount. The hope is that the alternative would be less costly than foreclosure for many such loans, which would be the incentive for mortgage holders to agree to it; that it would allow borrowers to remain in their homes with lower mortgage payments, which would be their incentive for agreeing to it; and that the written-down mortgage would be an acceptable risk for the government to assume in order to lessen the prospect of widespread foreclosures and all their related costs.

Having such an option available to the national banks supervised by the OCC, whether acting as mortgage holders or servicers, raises few safety and soundness issues because the program is voluntary. Indeed, if the option proved to be an attractive and less costly alternative to foreclosure as intended, it could save national banks significant amounts over time. And by keeping more borrowers in their homes, the widespread use of such a program could also help avoid further reductions in the prices of houses

financed by national banks more generally – making the mortgages less risky – by mitigating the downward pressure on house prices caused by the foreclosures that would be avoided.

The degree to which borrowers and mortgage holders would actually choose this new voluntary option is not clear, however. Based on our analysis of the particular features of the legislation and discussions with the national banks most active in the mortgage markets, there could be a number of situations in which the new option would not be an attractive alternative to foreclosure, despite its steep costs. This is due to a mix of factors that we describe in Section IV of our statement, which also includes our comments and suggestions. That discussion is preceded, in Section II, by our observations about recent developments affecting foreclosure rates, and, in Section III, by a brief discussion of the framework of the proposed legislation to provide a context for our comments in Section IV.

II. Foreclosures in the Current Climate

As has been widely reported, there were 1.3 million mortgage foreclosure starts in 2007. This was slightly more than double the average rate for the first half of the decade, which averaged 650,000 foreclosure starts per year from 2001 through 2006.[1] There are concerns that total foreclosure starts will increase to as much as 2 million in 2008, although it is possible that favorable changes in interest rates on adjustable rate mortgages (ARMs) may reduce this number. Subprime mortgages are a small percentage of the outstanding mortgage universe, but eclipse other types of mortgages in the

[1] The average annual rate of foreclosures started as a percent of loans outstanding from 2001-2006 was 0.44 percent, increasing to 0.71 percent in 2007, an increase of 27 basis points, or 61%. OCC staff bases this estimate on loan servicer survey data collected by the Mortgage Bankers Association.

foreclosure process. The onset of subprime defaults has jolted investors and triggered a far-reaching reassessment of risk across financial markets.

Today's hearing takes place in the context of a number efforts to meet the challenges presented by rising rates of foreclosure in the United States. The Hope Now Alliance and the American Securitization Forum have developed protocols and criteria that facilitate streamlined modification of securitized ARMs. Banking regulators have issued guidance encouraging servicers and lenders to pursue loan modifications instead of instituting foreclosure, when feasible and prudent. The FHASecure plan offers qualified mortgage borrowers that are in distress because of interest rate resets on ARMs the chance to refinance into new FHA-insured mortgages. Congress and the Administration have temporarily increased the maximum loan amount for FHA mortgage insurance, which makes the option available to borrowers in higher-cost housing communities for the first time. Community organizations and homeownership counseling groups are reaching out to distressed borrowers to assist in implementing these approaches, and banks are partnering with these organizations to try to reach more of their customers.

Adding momentum to these efforts has been the projected "payment shock" affecting subprime and Alt-A borrowers that is expected when initial fixed interest rates on hybrid ARMs "reset" to higher variable rates, with corresponding large increases to borrowers' monthly payments. This occurred in 2007, when resets typically resulted in payment increases of 25 percent or more. Expectations were that a much larger group of resets in 2008 would expand the group of distressed borrowers. However, since the beginning of the year, there has been a steep decline in short-term rates, and the indices

on which rate resets are based have fallen significantly. For example, six-month LIBOR was cut nearly in half, to fall below 3 percent. If rates remain low, depending on the type of loan product and its particular terms, many borrowers will experience much smaller or nominal payment increases and their mortgages will remain affordable.[2]

Of course, borrowers in the subprime and Alt-A sector continue to face substantial uncertainties. Early defaults by some subprime borrowers, even before their first interest rate reset, likely reflect the consequences of poor underwriting, or in some cases even fraud. For other borrowers, who may avoid payment shock on their ARMs in current market conditions, there remains the prospect of future loan rate and payment increases as short-term market rates eventually rise.

In addition, as a consequence of product terms and underwriting standards in prior years that allowed borrowers to obtain loans at or very near the full value of the property, recent property value declines leave borrowers owing more than their homes are currently worth – a situation often described as "negative equity." While this trend should eventually reverse and restore positive equity to these borrowers, it currently impedes refinancing into more affordable mortgages. And even if this were not the case, the market's return to more fundamental mortgage underwriting standards may make it difficult for many of these borrowers to refinance on affordable terms.

For these reasons, there is unlikely to be a single solution that can successfully address the multiplicity of competing interests at stake, and the differing circumstances

[2] *See* B. Grow, A. Zimmerman, and J. Kahan, *The Mixed Impact of Falling Rates on U.S. Alt-A and Subprime Borrowers* (Standard & Poor's RatingsDirect, March 26, 2008) (at March 2008 six-month LIBOR rates, "payment shocks" on average two-year hybrid ARMs reduced 95 percent; reduced 50 percent for average 3-year hybrid ARMs; and payment shock virtually eliminated on average Alt-A hybrid ARMs).

facing millions of borrowers. Thus, the introduction of new options, such as the new program initiated by the Act, could prove very constructive.

Moreover, thanks to data-collection efforts undertaken by the Hope Now Alliance, we are beginning to have a clearer picture of the dimensions of borrower defaults on subprime mortgages and the types of remedial activities being pursued by servicers in light of borrowers' circumstances. The OCC also is requiring our largest national bank mortgage servicers to provide comprehensive mortgage data that should contribute significantly to our understanding of loan delinquencies and defaults, and of efforts to prevent unnecessary foreclosures. We expect the data will cover more than 95 percent of all mortgage servicing activity in the national banking system; that is, it will not be limited to subprime mortgages serviced in securitization pools. The OCC is requiring this comprehensive mortgage data in order to ensure that we have a detailed picture of the activities of national bank servicers, the performance of loans serviced by them, and the types of foreclosure mitigation activities that seem to be workable.

III. The FHA Housing Stabilization and Homeownership Retention Act of 2008

The Act would provide an opportunity for many subprime and Alt-A borrowers to seek FHA-insured refinancing of their current loans on an affordable basis from private lenders under a new FHA insurance program. Refinancing would require that the servicer (or other holder) of the current mortgage voluntarily agree to accept the proceeds of the refinanced loan in full satisfaction of the borrower's obligation on the current mortgage. Those proceeds will be substantially less than the borrower's obligation under the current mortgage (commonly referred to as a "short payoff").

The FHA insurance coverage under this new program will be handled through a new fund, separate from the existing FHA insurance fund. The new fund will be financed through an initial insurance fee (not to exceed 5 percent of the insured loan amount) paid out of the refinancing proceeds on the current mortgage holder's behalf; an annual fee (not to exceed 1.5 percent of the outstanding loan balance) to be paid by the borrower; and a contingent exit fee to be paid by the borrower. This contingent exit fee will be payable to FHA upon subsequent sale or refinancing of the property only to the extent there are proceeds from the disposition left over after paying off the insured loan. The exit fee will generally be 3 percent of the original insured loan amount. However, during the first year of the refinancing, FHA would be entitled to all the net proceeds, and would continue to be entitled to a portion of the net proceeds in years two through five, declining by 20 percent each year. FHA's contingent claim would be secured by a second lien (commonly referred to as a "soft second") on the property. In addition, all existing mortgage holders – including holders of a second mortgage, such as from a "piggyback" purchase financing transaction or a home equity line – would have to agree to release their liens in order for the FHA refinancing to go forward.

The insurance program will be available for loans originated from January 1, 2005 until July 1, 2007 on 1- to 4-family properties. Only loans securing the borrower's principal residence are eligible, and the borrower's ratio of total mortgage debt to documented income as of March 1, 2008, must be at least 40 percent. The new loans will not be eligible for FHA insurance unless they are fixed-rate loans at current market rates, and the loan amount does not exceed 90 percent of the property's current appraised value. The loan must be underwritten based on the borrower's documented and verified income,

under terms established by HUD ensuring the borrower has a reasonable expectation of repaying the loan. The borrower's total debt obligations, including the new mortgage and other commitments, generally may not exceed 40 percent of income, though this figure may be somewhat higher if the borrower previously made similar payments for six months.

Title II of the Act establishes an Oversight Board comprised of the Secretary of the Treasury, the Secretary of HUD, and the Chairman of the Federal Reserve Board. This Board will establish an auction or other bulk facility that allows holders of mortgages to place group bids on FHA-insured refinancing of their loans. The auction facility will be available if the Board determines its use is necessary to stabilize the housing market and reduce the impact of turmoil in that market on the economy.

Title III of the Act would authorize appropriation of $10 billion in funds for grants to states for purchasing foreclosed properties at a discount and loans to individuals or entities seeking to acquire these properties for use as residences.

IV. Discussion of the Proposed Legislation

The Act is premised on a voluntary approach, under which servicers, acting on behalf of MBS investors and lenders holding loans on their balance sheets, will determine how to proceed. This is prudent and appropriate. Alternative approaches that would affect existing contracts could create litigation risks, and alteration of the fundamentals of agreements relied upon by mortgage lenders and investors could further retard confidence in and recovery of the secondary mortgage markets.

The usefulness of the approach taken in the proposed legislation would also be enhanced by provisions, like those in H.R. 5579, recently introduced by Representatives

Castle and Kanjorski, that clarify the obligations of servicers and provide reasonable and limited protection from liability for undertaking loan modifications, workouts, or principal writedowns. Servicers working with distressed borrowers face the difficult task of balancing the interests of borrowers and investors. Servicers perform these tasks in the context of pooling and servicing agreements that outline their contractual duties to investors in administering loan pools. H.R. 5579 would clarify that servicers should take actions that benefit all pool investors in the aggregate under these agreements. The alternate interpretation – that servicers cannot take action when it would result in conflicting impact on different classes of investors – could effectively paralyze servicers from taking any of the remedial actions specified in the agreements.

In short, the Act's approach is to offer FHA insurance that will make refinancing possible for an expanded group of borrowers on terms acceptable to current mortgage holders. Its success will hinge on a combination of factors, which may be complex. My testimony next highlights the factors we see as crucial to the scope and scale of implementation of the new program, and offers some suggestions.

Concessions from Current Mortgage Holders

The bill requires concessions from current mortgage holders, including principal writedowns and fee waivers. From the servicer's standpoint, these concessions may make sense if they will bring in funds that exceed (on a net present value basis) what the servicer can reasonably expect to obtain through other options. If the servicer is working with a borrower headed for foreclosure, the servicer can expect to have outlays for legal fees to obtain title to the property; expenses related to maintenance, taxes, and insurance; advances to investors for unpaid interest that continues to accrue on the mortgage;

marketing expenses for the property's resale; and most significantly, to sustain losses for the difference between the loan amount and the property's subsequent sales price. There can also be a lengthy period before foreclosure, during which the borrower makes no payments on the loan, and the overall period between default and subsequent sale of the property discounts the value of the proceeds eventually realized. State-by-state variations in procedures for trustee sales, deed-in-lieu, or judicial foreclosure affect these costs. Depending on the circumstances, these total costs and losses can be significant. Information from national banks active in mortgage servicing indicates that these losses (consisting of uncollected principal and unreimbursed outlays of the type described above) are typically in the 40 percent range, but will vary significantly depending on various factors.

If anticipated recoveries on foreclosure are less than the refinancing proceeds available to the current mortgage holder under the new program outlined in the Act, it would be rational for the servicer to choose the refinancing route. Before making this decision, however, the servicer is likely to assess borrowers' circumstances and evaluate their capacity to meet their existing mortgage obligations on modified terms instead. For example, modifications to subprime and Alt-A loans that make reasonable adjustments to the interest rate and term of the current mortgage can reduce a borrower's payment, without principal reduction, to the same amount it would be under a new loan for 85 percent of the existing principal amount. This allows borrowers to stay in their homes without any principal concession by investors. Moreover, we understand that investors are currently demonstrating a strong preference for rate and term modifications over principal concessions.

If, however, such modifications are not a viable alternative, the attractiveness of the refinancing option under the Act will depend on the extent of the principal compromise required. Under the Act, investors (and other current mortgage holders) would make principal concessions that equal the difference between the current mortgage loan balance and the proceeds of the new loan. The new loan amount will depend on two main factors that will vary from loan to loan: the current property value, and the size of the loan the borrower can incur consistent with the Act's underwriting standards. The loan proceeds ultimately retained by the current mortgage holder will also be reduced by the 5 percent insurance fee payable to FHA, and the amount of funds the servicer must advance to cover the borrower's payment deficiencies during the time it takes to arrange for refinancing of the defaulted loan, as well as other expenses. The full extent of the current mortgage holder's net principal loss can vary considerably under these factors, as illustrated in this example:

Original Loan: $250,000 30-year ARM at 8 percent initial rate

Property value:	$250,000
Borrower monthly income:	$3,500
Monthly payment:	$1,834
Mortgage debt-to-income ratio:	52%
Current loan balance:	$245,000

Example 1: Level Market, Level Income

- The Act imposes a 90 percent maximum on the loan-to-value ratio for the refinancing loan. If the value of the borrower's home has not declined since the original loan was issued, this would support a new loan amount of $225,000.
- However, the monthly principal and interest payments on a new fixed-rate 30-year mortgage at the current market rates for comparable loans (8 percent) would be $1,650. This would exceed the Act's underwriting ratio for borrower income, which generally limits the borrower's total debt to 40 percent of income.
- At the Act's 40 percent debt-to-income ratio, the borrower would be able to make payments of as much as $1,400 per month. This would support a new fixed-rate 30-year mortgage at 8 percent in the amount of $190,797:

Current loan balance:	$245,000
Less: new loan proceeds	$190,797
Less: 5% FHA fee	$9,540
Less: Servicer advances[3]	$14,167
Net proceeds recovered:	$167,090
Net loss percentage:	32%

- The Act allows increase of the 40 percent debt-to-income ratio to 50 percent if the resulting payments do not exceed payments the borrower successfully handled for

[3] Under pooling and servicing agreements, when a borrower has stopped making payments on a loan, the servicer is obligated to advance the interest accruing on the loan to investors, out of the servicer's own funds. The servicer must also advance its own funds to cover taxes and insurance on the property, and to cover all processing expenses. These examples assume the servicer would advance interest for 4 months (2 months delinquency and 2 months to completion of the refinancing), and that taxes, insurance, and other expenses would total 3 percent of the loan amount. The example does *not* include prepayment fees or penalties, which are to be waived under the bill.

six months under the current loan. The ratio can be increased even more, to 55 percent, if the increase is necessary to achieve the purposes of the Act and can be accomplished under reasonable underwriting standards. If we increased the borrower's debt-to-income ratio to 50 percent, with a payment of $1,750 a month under the same loan, this would support a new loan of $238,496:

Current loan balance:	$245,000
Less: new loan proceeds	$238,496
Less: 5% FHA fee	$11,925
Less: Servicer advances	$14,167
Net proceeds recovered:	$212,405
Net loss percentage:	13%

- Note, however, that this leaves the borrower with a payment that is only $84 less than the payment he or she already failed to meet on an intermittent basis. It also assumes that the borrower has no other debt to service, allowing half of his or her income to be allocated to servicing the new mortgage; this will not likely be the case for subprime borrowers, who typically have other debt.

Example 2: Income Re-underwriting

- Another factor affecting these outcomes is the Act's requirement to base the refinanced loan on documented borrower income. Many subprime and Alt-A borrowers have relied to a significant extent on undocumented income to qualify for their mortgages and make the required payments.

- If the borrower cannot document 25 percent of his or her original income, and must pay $350 each month on other auto and credit card debt, the funds available to service the new mortgage at a 50% debt-to-income ratio drop to $963, supporting a new loan of $131,241:

Current loan balance:	$245,000
Less: new loan proceeds	$131,241
Less: 5% FHA fee	$6,562
Less: Servicer advances	$14,167
Net proceeds recovered:	$110,512
Net loss percentage:	55%

Example 3: Declining Property Values:

- Given current market conditions, the property securing the current mortgage is unlikely in the short term to remain at its original value. As the property's value declines, the 90 percent loan-to-value limit in the Act begins to affect the current mortgage holder's recovery. If the property in our example has declined by 20 percent in value, consistent with current declines in certain areas of the country[4] and with property values in certain high-risk neighborhoods, it would now be worth $200,000. This would support a new fixed-rate 30-year mortgage at 8 percent in the amount of $180,000:

[4] One widely-reported home price statistic, the S&P/Case-Shiller Home Price Indices, tracks repeat sales in 20 U.S. metropolitan markets. These indices report 20 percent declines from 2006 peaks for three metropolitan areas as of January 2008. The composite index reports declines of 12 percent for the same period.

Current loan balance:	$245,000
Less: new loan proceeds	$180,000
Less: 5% FHA fee	$9,000
Less: Servicer advances	$14,167
Net proceeds recovered:	$156,162
Net loss percentage:	37.75%

As these examples demonstrate, investors' net losses can range from 10 to 55 percent, depending on circumstances and conditions. As compared to foreclosure costs averaging 40 percent, but which will vary significantly depending on various factors, the Act may not provide sufficient incentives for investors in some cases. Much depends on currently uncertain factors inherent in the Act's refinancing formula, particularly with respect to future property values, and with respect to actual refinancing loan amounts derived after application of the Act's borrower eligibility and underwriting standards to actual borrowers.

In addition, we are hearing anecdotal expressions of concern from some servicers that delinquent borrowers may seek the benefits of the program aggressively, even though they may have the capacity to pay their current mortgages under repayment plans or rate and term modifications, without the necessity of significant principal writedowns. Under the Act, a borrower would be eligible for participation in the program if his or her total mortgage debt constitutes at least 40 percent of documented income as of March 1, 2008, and if the borrower certifies that he or she has not intentionally defaulted. Significant numbers of current subprime and Alt-A borrowers would likely exceed this 40 percent threshold, given underwriting practices for these types of mortgages in prior

years and the widespread reliance on undocumented income by these borrowers to qualify for and make payments on these mortgages. Some servicers have expressed concern about the prospect of borrowers that meet the eligibility threshold who are current on their payments, thereby demonstrating their capacity to repay, deciding not to repay based on negative equity and the availability of the new program; that is, instead of continuing to repay they would refuse to negotiate on any basis other than a significant principal writedown.

The Problem of Second Mortgages

Another key issue faced by the proposed program under the Act, or any voluntary refinancing alternative for that matter, is how to deal with second mortgages. Industry data indicate that at least 30 percent of subprime mortgage borrowers also have a second mortgage, and the actual percentage is likely to be significantly more than 30 percent.[5] The bill authorizes HUD to take action as necessary and appropriate to facilitate coordination between senior and subordinate mortgage holders to facilitate their agreement to accept the proceeds of the refinancing loan as a short payoff and release their liens. Release of all existing mortgage liens is a prerequisite to insurance eligibility under the bill. Voluntary participation by any holder of a subordinate mortgage on each property therefore is just as essential to the program's success as voluntary participation by the senior mortgage holder. However, senior and subordinate mortgage holders have very different incentives that can impede their joint consent.

Recent declines in property values have left many subprime and Alt-A borrowers with insufficient equity in their properties to cover both their first and second mortgages,

[5] OCC staff bases this estimate on selected LoanPerformance data on the loans underlying securitizations comprising the following indices: ABX-06-1; ABX 06-2; ABX 07-1; ABX 07-2. However, the selected data may underreport second mortgages.

with the value of the home less than the value of the first mortgage. In such circumstances, the first mortgage holder remains at least partially secured by the reduced value of the home, while the second mortgage holder becomes unsecured until such time as the value of the home increases. Thus, even if the borrower is behind on the second mortgage, the holder is interested in avoiding foreclosure. That is, if foreclosure occurred immediately, the second mortgage holder would get nothing, while a delay in foreclosure would allow for both the possibility that the borrower's situation may improve over time (enabling resumption of payments and cure of the prior default) and the likelihood that property values will eventually recover and restore equity to the second lien. Even if property values only recover enough to restore partial equity to the second lien, the lender may be able to obtain a sizeable compromise payment when the borrower later wants to refinance or sell the property and needs the second mortgage holder to release the lien to clear title.

If foreclosure on the first mortgage is truly imminent, then the second mortgage holder is facing the prospect that its lien will be extinguished, resulting in an unsecured claim against the borrower for the debt. In those circumstances, a second mortgage holder has an incentive to accept a portion of the short payoff proceeds from a refinancing transaction under the bill, if that payment exceeds the second mortgage holder's expected recovery on the unsecured debt, which is likely to be low. Otherwise, however, a repayment plan or modification by the first mortgage holder is more consistent with the second mortgage holder's interests in retaining its position.

As a result, a second mortgage holder may lack incentives to release its lien to facilitate refinancing, unless a portion of the refinancing proceeds are used to make a

meaningful compromise payment on the second. However, this reduces payments to the first mortgage holder by what could be an unacceptable amount, given the first mortgage holder's concerns about principal concessions discussed above.

This suggests that it will be essential to understand the concerns that second mortgage holders have and to identify incentives they regard as workable. Otherwise, borrowers' inability to obtain their concurrence to refinancing is likely to delay and diminish the availability of relief under the Act. Issues include identifying ways to demonstrate that foreclosure is truly imminent and the second mortgage holder's expectation of recovery is small, indicating compromise for a smaller portion of the refinancing proceeds is warranted. In other circumstances, it may be advisable to allow a second mortgage holder to retain a subordinated lien for some amount on the property, but suspend the borrower's payment obligations until the future. The Committee may wish to consider adding explicit provision for this option in the Act.

Another issue, albeit one that arises less frequently, is that the second mortgage portfolios of a selected number of lenders are covered by private mortgage insurance (PMI). In this context, PMI typically provides partial first-loss coverage to the second mortgage holder. This coverage is usually paid after the foreclosure process has run its course, so that the amount of the lender's losses can be conclusively determined. What this means is that the second mortgage holder consenting to a non-foreclosure alternative could be facing the loss of a very substantial cash payment from the PMI insurer, unless the PMI insurer is willing to pay coverage based on the lender's write-down claim. Accordingly, further dialogue on second mortgage issues with interested parties should include the relevant PMI issuers.

Other Considerations

The Auction Facility. Title II of the proposed legislation leaves details about structure and function of the auction facility to be determined by the Oversight Board it establishes, so my comments necessarily only address several general and practical points. The auction facility is another promising tool to accomplish mortgage refinancings, potentially on a volume basis, but it would appear to present several practical issues. As an operational matter, institutions making bids to refinance groups of loans under the FHA's insurance programs will need underwriting information about the loans in order to determine a bid. Underwriting criteria for the insurance programs will therefore need to be geared to information the current mortgage holder has access to and can make available through the auction facility. Where this information involves uncertainties or qualitative judgments, the facility may need to incorporate pre-closing adjustment mechanisms such as put-backs that could impede overall efficiency of the process. The purchaser will otherwise be subject to the risk of becoming the owner of loans that do not qualify for FHA insurance. If such a purchaser depends on a warehouse line of credit to finance the loans pending closing of the refinancing transactions, its warehouse lender will be subject to similar risks.

Borrower Eligibility and Refinancing Criteria. Designing the borrower eligibility and underwriting standards involves a quite difficult balancing of competing concerns. On one hand, as previously discussed, conservative underwriting standards lead to significant reductions in the principal balance of the refinancing loans, and servicers are less likely to consider the option preferable to foreclosure, thus thwarting the Act's objectives. Importantly, however, insufficiently rigorous standards carry the risk of

further financial pain for borrowers and the risk of redefault (and resulting in increased losses to FHA and to lenders who participate in the refinancing part of the transaction). Additionally, changes in market factors (such as recent declines in short-term interest rates, for example) can have unexpected effects on borrower circumstances. Similarly, overly conservative standards for borrower eligibility can thwart the bill's objectives, while unnecessarily generous standards increase risk to the FHA.

The Committee may wish to consider building more flexibility into HUD's role in setting these standards. As an alternative, the Act might set a range for more of these standards, with HUD authority to establish – and adjust – the applicable standard. If experience with the program indicates it is not functioning as anticipated, or market conditions alter the landscape, this flexibility could be instrumental in making adjustments to achieve the Act's objectives.[6]

FHA Second Lien. The Act indicates that the borrower's obligation to pay the FHA under the soft second is limited to any net proceeds resulting from a sale or refinancing that remain after deducting the remaining balance of the FHA-insured loan. If a borrower obtains refinancing for the outstanding balance of the FHA-insured loan (such as many borrowers do when they refinance the existing balance to take advantage of declines in market interest rates), there will be no net proceeds available under the Act's formula, and the borrower will owe the FHA nothing. Similarly, nothing under the Act prohibits a borrower from entering into a collusive sale of the property to a related party at a price just sufficient to cover the outstanding balance of the FHA-insured loan,

[6] If the Act retains the test establishing the borrower's lack of capacity to pay at a 40 percent mortgage debt-to-income ratio as of March 1, 2008, consideration should be given to normalizing borrowers' outstanding obligations through a standard scale, such as a 30-year amortizing fixed rate calculation.

leaving no net proceeds under the Act's formula and no obligation to the FHA. These are topics where the legislation could direct HUD to develop standards to prevent windfalls and abuses.

Conclusion

In summary, alternatives to foreclosure can benefit borrowers, lenders, and investors. Designing alternative approaches that are both workable and fair, and aligning incentives to be sufficiently responsive to the needs of all the stakeholders, is a complex and delicate task. My testimony has outlined some ways in which the incentives the proposed legislation provides may warrant refinement – particularly the factors affecting the requirements for concessions from current mortgage-holders, and the need for incentives appropriate to obtain participation by second-lien holders. But the more options stakeholders have to address payment default, including through the proposed legislation, the greater the chances that foreclosure can be avoided.

We would be pleased to work with the Committee as the legislation is further developed to explore these and other issues.

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Statement of

Randall S. Kroszner

Member

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

April 9, 2008

Chairman Frank, Ranking Member Bachus, and other members of the Committee, I am pleased to be here today to discuss efforts to address the current problems in the mortgage and housing markets. In my testimony this morning, I will briefly review the current situation in the housing market and ongoing efforts to help prevent avoidable foreclosures. Then I will expand on what additional steps might be taken by homeowners, lenders, servicers, investors, and the Congress to address this important issue. I will also address the need to take the housing situation seriously and some aspects of the discussion draft of the Federal Housing Administration (FHA) Housing Stabilization and Homeownership Retention Act of 2008.

The Current Situation

The mortgage market has long been a source of strength in the U.S. economy, but it is facing very significant challenges today, especially in the subprime segment that serves consumers who have shorter or weaker credit records. In recent years, slowing home prices and a loosening of underwriting standards have contributed to sharp increases in delinquencies and foreclosures. As of January 2008, the most recent month for which data are available, about 24 percent of subprime adjustable-rate mortgages (ARMs) were 90 days or more delinquent, twice the fraction that were delinquent by this definition one year ago. For mortgages overall, more than 1.5 million foreclosures were started during 2007, up 53 percent from the previous year. All told, the consensus expectation is that the number of foreclosures in 2008 will likely exceed the number in 2007.

Both delinquency and foreclosure are traumatic experiences for the families and communities affected. Recent declines in house prices have eroded the equity that homeowners have in their homes, which has made it difficult or impossible for many of them to refinance their mortgage on more favorable terms compared to their current mortgage, even if interest rates

have declined since they took out their loan. Tighter lending standards have also limited opportunities for these families to refinance. When struggling homeowners cannot put themselves on a sustainable financial footing, neighborhoods also suffer--properties are not maintained and foreclosures, particularly when they are clustered together, put further downward pressure on house prices. This is bad news for investors, too, because as property values decline, the substantial costs associated with foreclosure rise even further. Finally, falling home prices can have local and national consequences because of the erosion of both property tax revenue and the support for consumer spending that is provided by household wealth.

Ongoing Efforts to Help Struggling Borrowers

Given the high cost of foreclosures to everyone involved--lenders, investors, borrowers and their communities alike--it is in everyone's interest to develop prudent loan modification programs and provide for other assistance to help borrowers avoid preventable foreclosures. Indeed, policymakers and stakeholders have been working hard to find effective responses to the increases in delinquencies and foreclosures. The steps that have been taken so far include initiating programs designed to expand refinancing opportunities and efforts to increase the pace of loan workouts.

One example of positive steps being taken is the effort by NeighborWorks America and the Homeownership Preservation Foundation to offer financial counseling services through the Homeowner's HOPE Hotline.[1] With the encouragement and leadership of the Treasury Department, the national Hope Now Alliance--a broad-based coalition of government-sponsored enterprises (GSEs), industry trade associations, counseling agencies, and mortgage servicers--is working to find ways to help troubled borrowers, particularly those facing interest rate resets,

[1] The telephone number for the nationwide Homeowner's HOPE Hotline is 888-995-HOPE.

through loan modification plans.[2] Recent actions by the Federal Open Market Committee to lower the target federal funds rate and resulting decreases in short-term interest rates also should help mitigate the problems associated with interest rate resets.

Useful steps also are being taken by the FHA, which provides insurance on a variety of fixed- and variable-rate mortgage products that can be used by borrowers who want to refinance their home and who meet specified underwriting and other criteria. For example, the agency recently established the FHASecure plan to help borrowers who are delinquent because of an interest rate reset and who have some equity in their home. FHASecure provides such borrowers the opportunity to refinance into an FHA-insured mortgage. Separately, the FHA's loan limits recently were raised significantly by the Economic Stimulus Act of 2008, further expanding the potential reach of the FHA's mortgage insurance programs. We understand that the FHA is studying additional ways that the agency's insurance programs could be expanded or modified, consistent with existing statutory authorities, to better help troubled borrowers.

The Federal Reserve has been working with financial institutions and community groups around the country to address the challenges posed by problem loans. For example, we have been providing community coalitions, counseling agencies, fellow regulators, and others with detailed analyses that identify neighborhoods with especially high concentrations of foreclosures. Last week the Federal Reserve made available to the public a set of dynamic maps and data that illustrate the regional variation in the condition of securitized, owner-occupied subprime and alt-A mortgage loans across the United States.[3] Armed with this information, community

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[2] Hope Now is an alliance between counselors, mortgage market participants, and mortgage servicers to create a unified, coordinated plan to reach and help as many homeowners as possible. For more information see: www.HOPENOW.com.

[3] The maps show data for each state and for most counties and zip codes. They are available on the website of the Federal Reserve Bank of New York at http://www2.newyorkfed.org/mortgagemaps.

organizations and leaders can better target their scarce resources toward helping borrowers in the greatest need of counseling and for other interventions that may help prevent foreclosure.

Communities also are searching for ways to address the challenges that foreclosed homes can present, such as decreased home values and vacant properties that can deteriorate from neglect. Toward this end, the Federal Reserve has recently engaged in a partnership with NeighborWorks America to identify effective strategies to stabilize neighborhoods that have large clusters of vacant properties due to foreclosures. Working together, we will develop materials and tools as well as convene training sessions to help communities build local capacity for acquiring and managing vacant properties. The ultimate goal is to return these properties to useful purposes, whether it is to provide affordable rental housing or to supply new homeownership opportunities in low- and moderate-income communities.

Loss-Mitigation Strategies to Reduce Foreclosures

In cases where it is not possible for the distressed mortgage borrower to refinance his or her mortgage into a more sustainable mortgage product, the next-best solution may be some type of loss-mitigation arrangement between the lender or servicer and the distressed borrower. The Federal Reserve, in conjunction with the other federal banking agencies (which include the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision), the Conference of State Bank Supervisors and the National Credit Union Administration, has issued guidance urging lenders and servicers to pursue such arrangements, when feasible and prudent, as an alternative to foreclosure. For the lender, servicer, and investor, working out a distressed loan with a struggling borrower makes economic sense if the net present value (NPV) of the payments under a loss-mitigation strategy exceeds the NPV of proceeds that would be received in foreclosure.

Loss mitigation can be advantageous to both the borrower and the lender because the costs associated with foreclosure can be very substantial. Historically, the foreclosure process has usually taken from a few months up to a year and a half, depending on state law and whether the borrower files for bankruptcy. Anecdotal evidence suggests that the time to complete a foreclosure has been increasing recently, as the number of foreclosures has risen and the average time that properties remain on the market has lengthened. The losses to lenders and investors from foreclosures include not only the missed mortgage payments during that period, but also the costs of taxes, legal and administrative fees, real estate owned sales commissions, and maintenance expenses. Additional losses arise from the often significant reduction in value when a property is repossessed even in stable housing markets, particularly if the property is unoccupied for some period. In fact, a recent estimate based on subprime mortgages foreclosed in the fourth quarter of 2007 indicated that total losses exceeded 50 percent of the principal balance. Whether the losses are that large in all cases is difficult to know, but what is known is that the foreclosure process itself destroys considerable value. The existence of such costs raises the real prospect that, by restructuring distressed loans in those cases in which the borrower wants to stay in the home, borrowers, lenders, servicers, and investors may *all* be able to achieve a better outcome than is attainable if the foreclosure process is allowed to run its course.

Lenders, servicers, and investors have historically relied on repayment plans as their preferred loss-mitigation technique. Under these plans, delinquent borrowers typically repay the mortgage arrears over a few months in addition to making their regularly scheduled mortgage payments. These plans often are most appropriate if the borrower has suffered a reversible setback, such as a temporary illness. However, anecdotal evidence suggests that even in the

best-case scenarios, borrowers given repayment plans redefault at a high rate, especially when the arrears are large.

Loan modifications, which involve any permanent change to the terms of the mortgage contract, may be preferred when the higher payments associated with a repayment plan do not result in a sustainable solution. In a loan modification, the borrower's monthly payment is reduced through a lower interest rate, an extension of the maturity of the loan, a write-down of the principal balance, or a combination of all three of these measures. The effort by the Hope Now Alliance to freeze interest rates at the introductory rate for five years for eligible borrowers with an adjustable-rate mortgage is an example of a modification, in this case applied to a class of borrowers.

To date, permanent modifications in this credit cycle episode, as in the past, have typically involved a reduction in the interest rate or an extension of the loan terms, while reductions of principal balance have been quite rare. But the current housing difficulties differ from those in the past, largely because of the pervasiveness of situations known as negative equity positions in which the amount owed on the mortgage exceeds the current market value of the property. A distressed borrower with a negative equity position may have neither the means nor the incentive to remain in the home. In this environment, servicers and investors may well find principal reductions that restore some equity for at-risk homeowners to be an effective means of avoiding delinquency and foreclosure.

Although principal write-downs may be especially germane today given the prevalence of negative equity positions, they are not necessary or appropriate for all borrowers who have negative home equity or who become delinquent on their mortgage. On the contrary, a strategy of targeting write-downs to certain groups of borrowers may provide the best path forward. For

example, one possibility would be to limit the availability of write-downs to those borrowers with high debt payment-to-income ratios and loan-to-value ratios significantly in excess of 100 percent before loan modification, but with the capacity to carry a written-down mortgage. In any event, it seems clear that principal reductions should be part of the tool kit that servicers and investors bring to bear as they deal with delinquent loans.

Additional Actions That Could Help Reduce Avoidable Foreclosures

Several steps could be taken to provide further impetus to loan modifications, including principal write-downs, in appropriate circumstances. One such step that could be taken relatively quickly by the industry is the development of a template that would guide servicers and others as they consider whether, and under what circumstances, to pursue various types of loan modifications, including principal write-downs. Enhanced guidance on loan modifications could help forge a common understanding among servicers and the investor community on when a particular loan modification tool is most appropriate. This guidance would help address the concern expressed by servicers that expanding the rate of principal reductions may expose them to increased litigation risks even in situations where the servicer reasonably determines that such action is beneficial to investors in comparison to other available options. The Hope Now Alliance organized by the industry and the Treasury Department successfully created guidelines dealing with interest rate resets. Leadership also is needed to provide guidance for other loan modification tools and to clarify the "best practices" to be followed by servicers in order to mitigate servicers' litigation risks.

The Congress can take another important step to facilitate greater use of loan modifications by moving quickly to reconcile and enact FHA modernization legislation permitting the FHA to increase its scale and improve the management of potential risks borne by

the government. Such legislation could improve the FHA's ability to reach a wider range of borrowers while allowing the agency to develop appropriate underwriting and pricing methodologies for any increased risks assumed.

Separately, the GSEs--Fannie Mae and Freddie Mac--could be asked to do more. Recently, the Congress has greatly expanded Fannie Mae's and Freddie Mac's role in the mortgage market by temporarily increasing the conforming loan limits for these GSEs. In addition, their federal regulator, the Office of Federal Housing Enterprise Oversight, has lifted some of the constraints that were imposed on these entities because they have resolved some of their recent accounting and operational problems. Thus, now is an especially appropriate time to ask the GSEs to move quickly to raise more capital, which they will need to take advantage of these new securitization and investment opportunities, to provide assistance to the housing markets in times of stress, and to do so in a safe and sound manner. As the GSEs expand their roles in our mortgage market, there is a strong need for the Congress to move forward on GSE reform legislation, including the creation of a world-class GSE regulator. As the Federal Reserve has testified on many occasions, it is very important for the health and stability of our housing finance system that the Congress provide the GSE regulator with broad authority to set capital standards, establish a clear and credible receivership process, and define and monitor a transparent public purpose--one that transcends just shareholder interests--for the accumulation of assets held in their portfolios.

Desirable Characteristics of an Initiative to Encourage Loan Workouts

Going beyond the current proposals for FHA modernization and permitting the FHA greater latitude to set underwriting standards and risk-based premiums for mortgage

refinancing--in a way that does not increase the expected cost to the taxpayer--would allow the FHA to help more troubled borrowers. For example, an FHA-insured refinancing product with insurance priced to reflect the risks to the taxpayers might encourage servicers to consider providing delinquent, at-risk mortgage borrowers a principal write-down as a loan modification alternative. The draft FHA Housing Stabilization and Homeownership Retention Act of 2008 includes provisions designed to allow the FHA to offer such products, which could be a useful tool in helping reduce preventable foreclosures.

As you move forward in considering whether to enact a bill and, if so, what its precise design should be, it will be important to consider a wide range of issues. In many cases, a judgment must be made as to how to strike an appropriate balance among competing considerations. Among the issues you will have to consider are at least the following five:

1. *Mitigating moral hazard.* Homeowners who can afford to pay their current mortgage should not be encouraged to default in order to qualify for a write-down. To discourage borrowers who would otherwise have the ability to continue making their payments from becoming delinquent, a variety of steps could be taken. For example, eligibility for assistance under the program could be restricted to borrowers who had relatively high debt payment-to-income ratios at some specified date before the creation of the program. In addition, steps could be taken to make it costly for homeowners who attempt to quickly cash-in on the equity provided through a principal write-down. For example, participating borrowers could be required to pay an exit fee when the refinancing loan is extinguished. As another example, borrowers could be required to share with the government or with the holder of the borrower's existing mortgage either the equity created through a write-down or the future

appreciation in the home price, or both, over some specified time period. In other words, the government or investor would have what is known as a "soft-second." In addition, programs that provide for the voluntary participation of lenders and servicers should provide a natural brake on moral hazard, as lenders and servicers would remain free to pursue other options available to them in situations where they believe the borrower has the ability to repay his or her existing mortgage.

2. *Mitigating adverse selection.* A robust defense against adverse selection--the incentive of current servicers or lenders to send only their worst credits to the government-insured mortgage program--is necessary to protect the interests of the taxpayer. Mechanisms that would discourage adverse selection include: (i) a loan seasoning requirement (for example, a period during which the new loan could be sent back to the original servicer/lender if it redefaults) and (ii) a fee structure that imposes costs on the servicer/lender if the new government-insured loan goes bad within a specified period or pays a bonus if the loan continues to perform over the whole of that period.

3. *Turning the FHA into a world-class mortgage insurer.* With modernization and expansion, the FHA could play an important role in relieving stress in the mortgage and housing markets as well as in restarting securitization markets. Securitization markets are needed to help relieve capital stresses on banks and to provide more affordable mortgages to borrowers. To this end, more consideration needs to be given to how the FHA can scale up quickly and improve its processes and underwriting systems so that they are comparable in quality with those currently being used by Fannie Mae and Freddie Mac. In addition, providing the FHA with

broad authority to offer innovative products that meet market needs and to outsource loan underwriting and other program elements to private-sector providers could allow the FHA to insure more mortgage borrowers and to do so more quickly. The FHA needs to be better able to compete in today's marketplace and it needs access to the best risk-management tools available when managing the risks to the government.

4. *Protecting the taxpayer.* Any government-insured mortgage offered under a refinancing program needs to be prudently underwritten, regardless of whether a principal write-down is part of the deal. First and foremost, this means establishing a meaningful amount of homeowner equity. Second, it means using sound underwriting criteria to ensure that borrowers are reasonably likely to be able to repay the government-insured loan on a sustained basis. Third, it means allowing the FHA to engage in sensible risk-based pricing of its mortgage insurance products, including substantial flexibility in setting its initial premium and annual premiums.

5. *Negotiating junior liens.* From one-third to one-half of all subprime mortgages pertain to properties that also have junior liens. When held by an entity other than the first lien holder, these junior liens present a variety of serious obstacles to a successful refinancing, especially one involving a principal write-down. Typically, the junior lien holder must agree either to remove his lien in return for a portion of the proceeds from the refinancing or re-subordinate his claim to the new loan. The valuation of the junior lien holder's claim on the property is often difficult to negotiate. One way of dealing with this problem in the case of a restructuring with an FHA-insured mortgage is to offer a junior lien holder a specified share of the government's or investor's "soft second." Another way of dealing with junior liens is

to provide the servicer with financial incentives to aggressively negotiate with the junior lien holder while capping any potential payout available to the junior lien holder from the government program.

Elements of these considerations are already reflected in the discussion draft. For example, Title I of the discussion draft includes exit fees and shared appreciation mortgages to address concerns about borrower moral hazard. It also contains features to protect the taxpayer, such as widening the range of insurance premiums and creating a meaningful amount of borrower home equity. As for adverse selection, risk-based insurance premiums paid by the servicer are crucial, and Title I could be clearer about the FHA's authority to use risk-based premiums. Other steps to guard against adverse selection could include a loan seasoning requirement or other forms of warranties given by the lender to the government about loan performance.

Given the magnitude of the potential foreclosures on the horizon, more steps should be taken to modernize the FHA and to deal with the junior lien holders. The FHA needs the resources and the incentives to manage the risks to the government well and to offer mortgage insurance products that will be attractive to servicers. As for junior lien holders, despite the government's best efforts, it may be difficult for servicers or lenders to negotiate with junior lien holders on the borrowers' behalf. The FHA needs substantial flexibility to provide incentives to servicers to negotiate with junior lien holders to address this difficult problem.

The Congress may be concerned that the loan-by-loan approach could prove insufficient. Title II of the discussion draft would permit substantial flexibility to expand the program if needed by introducing a bulk-refinance mechanism if economic conditions warrant such action. This mechanism would rely on an auction-based process to price and deliver mortgages for

refinancing. Note that an auction-based approach would still have to contend with some of the problems mentioned above, including moral hazard, adverse selection and the resolution of junior liens. Title II would grant authority to the implementing agencies to build in features needed to address these and other issues. If you move forward with this legislation, it will be important that the implementing agencies have full latitude to exercise such authority.

In the design and details of a principal write-down program based on a government-insured refinancing, it is critical to strike the right balance between the interests of borrowers, servicers, investors, and taxpayers. For example, the larger the required principal reduction on a troubled loan, the fewer loans that lenders or servicers will offer voluntarily for refinancing into an FHA-insured product, thereby reducing the "take up" rate for the program. However, a larger principal write-down better protects taxpayers from future losses and gives the borrower a greater incentive to stay current on the refinanced mortgage.

As another example, the more incentives given to servicers to use an FHA refinancing program, either through direct payments or through shared appreciation agreements, the more they would be willing to incur the costs of refinancing borrowers. Such incentives might increase the number of borrowers who might be considered for a government-backed program. But such incentives also would raise the cost of the program for the borrower and possibly for the government as well.

As a final example, providing investors with some of the benefits of any shared-appreciation agreements might encourage them to allow servicers to write down principal and refinance borrowers into a government-backed program. However, providing the government with such agreements could be one means of compensating taxpayers for shouldering the risks associated with the program.

Even if the right balance for the program can be struck, obstacles remain to the successful implementation of a government program designed to forestall preventable foreclosures. For example, even though workouts may often be the best economic alternative, mortgage securitization and the constraints faced by servicers may make such workouts less likely. Trusts vary in the type and scope of modifications that are explicitly permitted, and these differences raise operational compliance costs and litigation risks for the servicer. So that servicers do not try to unduly avoid litigation risks, leadership is needed to clarify their duties.

Conclusion

FHA modernization and GSE reform are needed to address the ongoing shortcomings of current mortgage-oriented government initiatives. In addition, the GSEs should be strongly encouraged to raise additional capital so that they can fulfill the expanded role that the Congress has recently extended to them.

Separately, the Congress should carefully evaluate whether to take additional actions to reduce the rate of preventable foreclosures. Properly designed, such steps could promote economic stability for households, neighborhoods, and the nation as a whole. Although lenders and servicers have scaled up their efforts and have adopted a wider variety of loss-mitigation techniques, more can, and should, be done.

The fact that many troubled borrowers have properties that are now worth less than the principal amounts remaining on their mortgages suggests that lenders and servicers should give greater consideration to the use of principal reductions as one of the loan modification options in their tool kit. Principal write-downs would be facilitated by providing the FHA the flexibility to insure a broad range of refinancing products for a larger number of at-risk borrowers, including products that offer borrowers an affordable, restructured mortgage if their lender voluntarily

agrees to write-down the principal amount of the borrower's mortgage. The voluntary nature of the program assures that only borrowers who the servicer or lender believes cannot successfully carry their current mortgage contract would be considered for such a program. If the Congress decides to move down this road, it should carefully consider the steps that should be taken to mitigate moral hazard, avoid adverse selection, and ensure that the financial interests of the taxpayer are adequately safeguarded.

STATEMENT OF BRIAN D. MONTGOMERY

Assistant Secretary for Housing – Federal Housing Commissioner
U.S. Department of Housing and Urban Development

Hearing before the Committee on Financial Services
United States House of Representatives

"Using FHA for Housing Stabilization and Homeownership Retention"

April 9, 2008

Thank you, Mr. Chairman. I appreciate the invitation from you and Ranking Member Bachus to testify this morning.

The Administration has taken decisive action to help responsible homeowners stay in their homes. The Administration launched the *FHASecure* initiative and facilitated the creation of the HOPENOW Alliance, which together have helped more than a million struggling homeowners.

Mr. Chairman, I think we all agree that we must use government resources wisely and judiciously. We must help responsible families in need, without transferring risks and costs that should be borne by the private sector to the taxpayer. I know that we all want to find a way for FHA to help more Americans keep their homes and avoid foreclosure.

However, I believe most Americans want to protect homeowners who played by the rules. They don't want to reward risky financial behavior. And they don't want to make the Federal government the lender of last resort, with the private sector dumping bad paper on FHA and taxpayers.

We must not federalize the housing market. And we must not harm our economy through solutions that, however well intentioned, further erode the foundation of the nation's housing market, hurt homeowners who are meeting their mortgage obligations, or prolong the correction.

Mr. Chairman, Congressman Bachus, this Administration has acted swiftly to address our housing problems and we are prepared to do even more. There are some good ideas embodied in legislation under consideration, including your own. But some ideas stretch FHA well beyond its role or ability to serve the American people appropriately.

For the last two years, the Administration has suggested ways to improve the agency's ability to fulfill its mission to help low-income and first-time homebuyers who are not served by the conventional mortgage market. I believe FHA should remain true to its mission. FHA Modernization is one constructive step, a step I know you have strongly supported, Mr. Chairman and Congressman Bachus. And I want to thank the Committee for that bipartisan support. The Administration continues to urge Congress to reach agreement on a bill to modernize FHA that the President can sign it into law.

However, Mr. Chairman, there are two key components that must be part of any final FHA Modernization bill.

First, we must maintain FHA's ability to offer a fair and equitable mortgage insurance premium structure that is commensurate with the risk presented by the loans it insures. Any bill must give FHA the tools needed to price for additional risk. Unfortunately, neither the House (H.R. 1852) nor Senate (S. 2338) provisions succeed in accomplishing this. Instead, the Senate bill would impose a 12-month moratorium on HUD's proposed modification to the current FHA premium structure. To ensure the solvency and continued operation of FHA's single family mortgage insurance fund, flexible risk-based premiums are necessary both now and in the future. FHA currently is self-sustaining. As you know, few government programs can claim the same. We do not want to cross that line, particularly at a time when we are most needed, and as I have

testified to other Committees, reforms or changes to the program are already needed to avoid crossing the line in October at the start of FY 2009.

Second, legislation must include a provision, like that in S. 2338, to expressly prohibit down-payment assistance from the seller or any other person or entity that stands to benefit from the transaction financially. Insured loans relying upon seller-funded down payment assistance have been demonstrated to have an unacceptably higher risk of default and foreclosure – harming borrowers they intend to help and risking the integrity of the entire FHA program and its ability to help more at-risk low- and moderate-income homeowners. Data clearly demonstrates that FHA loans made to borrowers relying on seller-funded downpayment assistance go to foreclosure at three times the rate of loans made to borrowers who make their own downpayments. We simply cannot sustain this business. We want FHA to be here not just for this generation, but for generations to come.

FHA Modernization has bipartisan support. It is the appropriate next step to address the housing downturn. Congress needs to make this important bill an immediate priority over other housing proposals that are under consideration. As a first order of business, a good FHA Modernization bill must be sent to the President.

In addition to FHA Modernization, the Administration believes that additional, responsible actions can and should be taken with respect to expanding temporarily the *FHASecure* program. We think there is more we can do with *FHASecure*, rather than creating a new refinance product. The Administration announced this program last year to help more low-to-moderate income families who could not otherwise qualify for prime-rate refinancing. To date, we have served more than 150,000 homeowners in need, and our projections show that we will likely reach more than 400,000 families by year's end.

We believe that the reach of this program can and should be extended in a responsible way. Any expansion of *FHASecure* should continue its temporary nature and be focused on helping homeowners who are financially able and responsible, but who cannot refinance and stay in their homes without FHA assistance.

Expansion of *FHASecure* also would need to be achieved in a way that is consistent with the Administration's principles on FHA Modernization. An expansion of *FHASecure* should include special underwriting flexibility to help more families qualify for FHA-insured mortgages. This includes making eligible more borrowers who were late on a couple of mortgage payments. These underwriting changes could also be made in exchange for lenders voluntarily writing down some of the outstanding mortgage principal if necessary to attain a prescribed loan-to-value ratio, and/or balanced with insurance premium adjustments when necessary to protect both the FHA insurance fund and the taxpayer. Again, FHA operates as a negative credit subsidy program, which means that it does not require Federal appropriations for its credit subsidy cost. Rather, the FHA program is funded through insurance premiums that homeowners pay themselves.

I believe these actions are consistent with our shared view that a robust FHA is needed to address the housing situation. However, it is essential that Congress not legislate specific underwriting criteria that would unnecessarily limit FHA's flexibility.

Certain bedrock principles also need to be maintained. For example, we require that an eligible family live in the FHA-insured home and have documented, verifiable income. That's something that FHA has always done, but in the era of no-doc loans, was a bit of an anomaly. As you know, Mr. Chairman, many of the problems in the housing market have occurred as a result of lax underwriting standards, and FHA should not be forced legislatively to compromise its fundamental criteria at the future expense of the taxpayer. Furthermore, any expansion of the program should allow FHA to establish a new and more flexible pricing policy for its insurance products at rates sufficient to ensure the safety and soundness of the single family mortgage insurance fund. Basing mortgage insurance premiums on the individual risk of each loan, where risk is judged using traditional underwriting standards, is the best way to ensure that the taxpayer is protected and that FHA can help more families stay in their homes. It's how every responsible insurance company operates.

Mr. Chairman, I will now comment on the specifics of the legislation that brings us here today.

While we appreciate many of the concepts that underlie Title I of your bill, the Administration has serious concerns about several provisions. For example, we have concerns that Title I in the draft House bill is not sufficiently targeted and mandates a loosening of underwriting criteria that could saddle borrowers with unacceptably high debt payments, placing them and the FHA fund at risk. We are concerned about the bill's very prescriptive approach. For example, your proposal would have lenders disregard some underwriting criteria and allow borrowers with much higher debt-to-income ratios to be eligible. Preserving FHA's administrative flexibility, to help homeowners and protect taxpayers, is important. The mandatory write-down of principal on the part of existing lien-holders and compulsory waiver of prepayment penalties suggest that Congress expects lenders and investors to simply accept losses, regardless of the contractual obligations imposed by the securities in which the loans are held and the market conditions affecting the borrowers. In addition, the bill requires lenders to disregard current credit scores or delinquencies on existing mortgages when assessing whether a borrower has a reasonable expectation to pay the mortgage. The bill also would allow FHA to insure borrowers with much higher debt-to-income ratios than we think is appropriate.

Instead of creating a new program in another account, we support expanding *FHASecure* within the Mutual Mortgage Insurance Program Account while increasing its aggregate loan guarantee limit so that FHA can serve more needy borrowers. Finally, the "exit premium," to be structured as a subordinate lien payable to FHA, could accomplish the same goal through a simple deed restriction without requiring additional legislative authority. In essence, we believe that there are simpler and more targeted ways to accomplish the goals of the bill, relying on the existing market forces and practices.

We also strongly oppose Title II and similar provisions in the Senate version that would allow lenders or servicers to sell bad loans to the taxpayers through an auction process, clearinghouse, or some other wholesale mechanism. We do not believe that it is necessary to create an

Oversight Board and a new auction mechanism in order to encourage mortgage holders to sell portfolios at a discount to new investors whose servicers would write down the existing mortgages as permitted under Title I. The market does not need a government entity to play this role in such a transaction and the capacity of the board will be fairly limited. With the *FHASecure* expansion, these sales can occur in the private market, because the potential purchasers will be able to refinance new loans under FHA's rules that permit the write down and refinancing of delinquent loans.

We strongly oppose Title III of the draft House bill as well, which would provide $10 billion in loans and grants to States and local governments for the purchase and rehabilitation of vacant, foreclosed homes. In addition to being extremely costly, such a program would constitute a taxpayer bailout of lenders and speculators, while doing little to help keep struggling families in their homes. As with similar proposals, the principal beneficiaries of this type of plan would be private lenders, who are now the owners of the vacant or foreclosed properties. In addition, it may have the unintended consequence of making foreclosure a more attractive option for lenders. While community stabilization is a worthy goal, using Federal resources to purchase properties from lenders who could already be helping to prevent the foreclosures represents a clear moral hazard. Lenders can and do already work with state and local governments to transition excess properties to good public use; a new program of this scope may do more harm than good.

Mr. Chairman, these are our initial thoughts about the bill. I again stress that there is a lot of common ground here given our shared interest in using FHA to help many Americans. I look forward to working with you and the Committee to do just that. Thank you again for inviting me to testify today.

Embargoed until
April 9, 2008, at 10:00 am

Statement of

John M. Reich
Director, Office of Thrift Supervision

regarding

Using FHA for Housing Stabilization and Homeownership Retention

before the

Committee on Financial Services
United States House of Representatives

April 9, 2008

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Statement required by 12 U.S.C. 250: The views expressed herein are those of the Office of Thrift Supervision and do not necessarily represent those of the President.

STATEMENT OF JOHN M. REICH
DIRECTOR, OFFICE OF THRIFT SUPERVISION
ON USING FHA FOR HOUSING STABILIZATION
AND HOMEOWNERSHIP RETENTION
BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

April 9, 2008

I. Introduction

Good morning, Chairman Frank, Ranking Member Bachus and members of the Committee. Thank you for inviting me to testify on how to turn back the rising tide of home foreclosures in America and particularly on the views of the Office of Thrift Supervision on the FHA Housing Stabilization and Homeownership Retention Act of 2008. I'd like to commend you for your diligence and leadership on this important subject. I'd also like to thank you for the cooperative approach and exchange of ideas that my staff has had with yours as we and others work toward this essential common goal.

In my testimony today, I will first address how changes in the underlying housing market are having an impact on thrift lenders. Key measures of financial health – including earnings and profitability, loan loss provisions and net charge offs, and loan performance – have been affected by the downturn in the housing economy over the past year. While industry capital remains strong and asset quality is relatively stable, we are maintaining a watchful eye on loan performance and industry exposure to the fallout from problems in the subprime mortgage market. We are also closely monitoring thrift industry exposure to upcoming resets on prime pay-option adjustable rate mortgages (ARMs) that are expected to occur in the next several years.

While a generally favorable interest rate environment continues, the thrift industry's high levels of earnings and profitability from several years of mortgage originations and sales has abated. Although thrift earnings have been challenged in recent quarters, industry capitalization has remained strong due, in part, to good stewardship by thrift managers, who have taken steps to address this challenging business environment.

This is an important backdrop for our discussion because a strong and vibrant thrift industry, supervised by a regulator with experience and specialized expertise in mortgage markets and mortgage finance, must be an integral part of any plan to preserve

homeownership, prevent unnecessary foreclosures, and address other problems that may be caused by the inevitable periodic fluctuations in the housing and mortgage markets.

I will also discuss the FHA Housing Stabilization and Homeownership Retention Act of 2008, as well as the OTS Foreclosure Prevention Proposal. Both seek to preserve homeownership and limit preventable foreclosures through the use of FHA loan programs. Our continuing work in developing and fine-tuning the OTS Foreclosure Prevention Proposal has included extensive conversations with mortgage market participants and stakeholders, and allowed us to identify and study the issues involved. In this process, we have gained key insights into the incentives that drive the behavior of these mortgage market participants--incentives that present both obstacles and opportunities that must be considered in fashioning an appropriate strategy for addressing the challenge that we face.

II. State of the OTS-Regulated Thrift Industry

A. Thrift Industry Data/Numbers

1. Overview

The OTS-regulated thrift industry comprises a diverse group of institutions that range from small one-office depositories to large and complex institutions that operate on a nationwide basis. As of December 31, 2007, OTS supervised 826 thrift institutions with combined assets of $1.51 trillion. Of these institutions, 39 percent were held in the mutual form of ownership, the historical form of thrift ownership, and 61 percent were stock held depositories. Virtually all stock held institutions operate within some form of a holding company structure.

The majority of OTS-regulated thrifts are full-service, community-based financial institutions offering a wide range of products to consumers and small- to medium-sized businesses. Although most thrift institutions use the charter to specialize in retail mortgage and consumer lending activities, some institutions have a more narrowly focused business strategy. These other operating strategies typically involve a market niche or more narrowly focused business model such as a trust-only charter, a credit card lending focus, or mortgage banking operations.

While there is some diversification with the use of the thrift charter, savings and loan holding companies (SLHCs) are even more diverse. SLHCs are involved in a wide range of businesses and activities, and range in size from small shell holding companies to large international conglomerates. While the predominant characteristic of most SLHC activities involves financial services, there are a number of SLHCs that conduct

operations in numerous non-financial activities, including manufacturing, industrial and retail operations. Among the larger and more complex companies that own thrifts are investment banking firms, insurance companies, and diversified financial services firms with international scope.

As of December 31, 2007, the OTS supervised 475 SLHC structures – including 109 mutual holding company structures – with aggregate consolidated assets of approximately $8.5 trillion.

2. Industry Performance

The profitability of mortgage market participants was especially hard-hit in 2007 and this had a significant impact on overall thrift profitability for the year. The OTS-regulated thrift industry posted profits of $2.9 billion for 2007, down from $15.8 billion in 2006. The industry's return on average assets was 0.19 percent for 2007, compared with 1.06 percent for 2006.

Of particular note, the industry recorded a loss of $5.2 billion in the fourth quarter of 2007, a record in terms of dollars, which equated to a 1.38 percent return on average assets for the quarter. While goodwill write-downs of approximately $4 billion by a handful of institutions and a $2.2 billion restructuring charge by one institution were significant components of the aggregate industry loss for the quarter, record levels of loan loss provisioning also played prominently in fourth quarter industry performance.

While nationwide home sales slowed throughout 2007, thrift industry mortgage originations (including 1-4 family and multifamily lending) rose for the year. Total industry mortgage originations were $716.1 billion in 2007, up 12 percent from $642.2 billion in 2006. While total industry originations of $166.6 billion in the fourth quarter were down from $185.7 billion in the third quarter of 2007, the fourth quarter of 2007 was still significantly higher than the $134.3 billion of industry originations in the fourth quarter of 2006.

Thrifts continue to account for a sizable portion of the U.S. residential mortgage market, originating 31 percent of total 1-4 family loans in the fourth quarter of 2007. An estimated 9 percent of thrift mortgage originations were ARMs in the fourth quarter of 2007, down from 13 percent in the third quarter of 2007 and from 12 percent of all thrift originations in the fourth quarter of 2006.

Thrifts currently hold approximately two-thirds of their assets in mortgages and mortgage related instruments. As of December 31, 2007, one-to-four family mortgage loans constituted 48.9 percent of industry assets (including 7.5 percent of assets in home equity lines of credit); 4.1 percent of industry assets were in multifamily loans and 13.7 percent of industry assets were in other mortgage related instruments. Of total

outstanding one-to-four family mortgages and mortgage related instruments held by the industry, approximately 61.2 percent were ARMs.

With the impact of a weak housing market on thrift balance sheets, institutions are taking appropriate steps to protect their operations. Thrift regulatory capital measures also remain strong. As of the end of 2007, 98.5 percent of all thrifts – holding 99.8 percent of industry assets – exceeded the "well-capitalized" regulatory standards. Regulatory capital measures exclude goodwill, so these measures were unaffected by the large goodwill write-downs taken in the fourth quarter. In addition, thrifts continue to add to their loan loss provisions, which increased to 0.75 percent of average assets for the year from 0.25 percent in 2006. The additions to loan loss provisions reflect the increase in non-current loans as a result of the deteriorating performance of loans originated in the past several years.

B. Market Conditions and Challenges

1. The Current Housing Economy

The slump in the housing market continues to adversely impact loan production and performance. Non-conforming loan[1] originations fell 49 percent in the fourth quarter, as the secondary market for bonds backed by the collateral remained shuttered. According to data collected by Inside Mortgage Finance, only $84.5 billion of non-conforming loans were originated in the quarter ended December 2007, representing just 19.9 percent of total loan production. This was well below the peak origination period of 2005, when the total reached $1.58 trillion or 50.4 percent of all production. Production of jumbo loans fell 47 percent to $44.0 billion, or less than 10 percent of all originations, while Alt-A and subprime production volume plummeted to $27.0 billion and $13.5 billion respectively. In contrast, FHA/VA loan production rose steadily in 2007 from a low of $19.0 billion in the first quarter to $31.0 billion at the end of the year.

Home construction also impacts the performance of thrifts, and activity continues to trend downward. Housing starts for both single- and multi-family dwellings in February were down 28.4 percent from a year earlier and more significantly, were 33.2 percent lower in the last three months. The annual production of single-family homes fell to its lowest level since 1991 at 707,000 units.

According to the U.S. Department of Commerce, purchases of new homes -- often a leading indicator of housing conditions -- fell to a 13-year low of 590,000 (annualized) units in February. This was a 29.8 percent decline in sales from a year earlier and was the worst sales decline since record-keeping began in 1963. The number of new homes

[1] Non-conforming loans are defined as jumbo, subprime, and Alt-A loans for purposes of this document.

for sale fell to 471,000 in February, but given the current sales pace, it would take 9.8 months to sell these homes -- the highest number of months since October 1981.

In February 2008, sales of existing homes, which account for 85 percent of all home sales in the U.S., fell 24 percent from a year go to 5.03 million units, the largest yearly slump in more than a decade. According to the National Association of Realtors, the inventory of existing homes available for sale stands at 9.6 months (assuming the February sales pace), less than the 10.3 months in January, but near the peak levels reached in October 2007. The median sales price of an existing single-family home fell 8.2 percent on a year-over-year basis in February.

Mortgage loan performance also deteriorated in January 2008, as reported by LoanPerformance.[2] The national delinquency rate for prime loans climbed to 3.45 percent, nearly a percentage point higher than a year earlier. The most significant increase in late payments was exhibited by subprime borrowers, with both fixed rate and ARM loans, where the pace rose to 21.31 percent, more than 7 percent greater than in January 2007. Foreclosure rates also climbed higher in all loan categories, with the greatest gain among Alt-A and subprime homeowners.

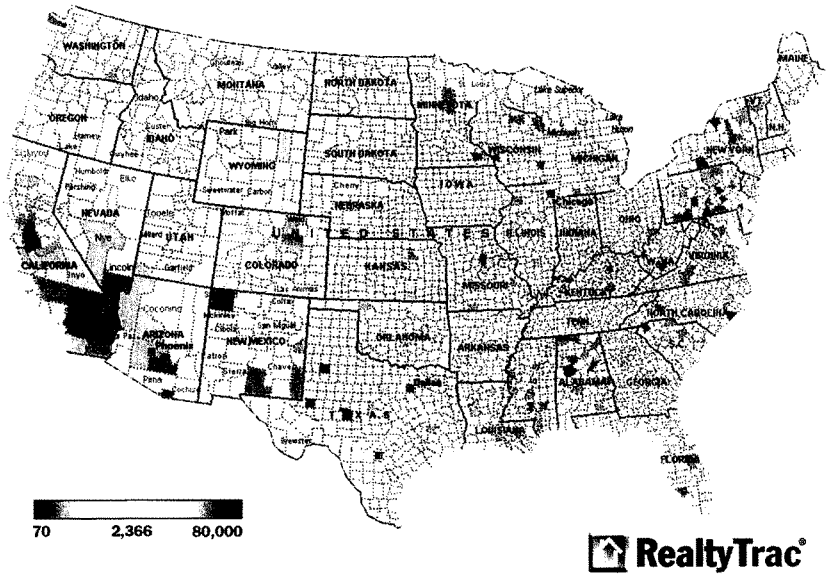
2. The Mortgage Markets

Home prices, as reported by the S&P/CaseShiller Home Price Index (HPI), continue to weaken. The January 2008 HPI for 20 U.S. cities showed a 10.7 percent annual decline in home prices, the thirteenth consecutive month the index has fallen. Nineteen of the 20 metropolitan areas in the index reported annual price declines, with Charlotte the only city to report a gain. Sixteen of the metropolitan areas reported record price declines, with Las Vegas and Miami sharing the top spot for the largest annual decline, 19.3 percent, in home prices during the month. The impact of falling home prices may eventually improve the pace of home sales, but may also exacerbate the number of mortgage defaults. Coupled with the fact that many mortgages in recent years have been issued with "simultaneous seconds" (i.e., second mortgages issued to borrowers in lieu of the imposition of private mortgage insurance), many mortgages currently have high loan-to-value (LTV) ratios on the combined first and second mortgages.

The combination of high LTV ratios and the decline in home prices is forcing many mortgages "underwater," - a situation in which the borrower owes more than the home is worth. This has had a dramatic effect on increased foreclosure rates. As evidenced in the following chart from RealtyTrac.com, higher foreclosures rates are no longer isolated to the previously "hot" real estate markets, but are now evident in many areas of the country.

[2] LoanPerformance is a subsidiary of First American Real Estate Solutions.

Households per Foreclosure Action – February 2008



The bulk of 2/28 and 3/27 ARMs originated in 2005 have experienced their first rate reset. However, the FDIC has estimated that there are 1.3 million loans scheduled for rate resets in 2008, and there are many prime option ARMs approaching their first rate reset, which has the potential to produce further increases in mortgage loan delinquencies.

While there are different projections and estimates of the impact of rate resets on an already volatile housing market, we know that neither subprime nor option ARM rate resets have peaked. Coupled with the possibility that many resetting loans may already be underwater, upcoming rate resets pose serious challenges, and potential opportunities, for thrift mortgage lenders. Now is the time to identify creative approaches to addressing these problems. And it is my intention that the OTS and the thrift industry play an important role in ensuring the continued viability, sustainability, and affordability of the U.S. housing markets.

III. Foreclosure Prevention and Loss Mitigation Efforts

A. Overview of Affected Parties/Participants

In exploring foreclosure prevention solutions, it is important to understand the interests of the various participants when a mortgage loan is made and, in many cases, subsequently securitized.

The first group of affected participants is the borrowers. Even within this group, however, there is not a single borrower profile. This, of course, complicates appropriate responses and solutions aimed at assisting borrowers on a blanket or wide-scale basis. Generally, distressed borrowers can be sub-grouped into three broad classes:

- Borrowers not able to sustain the financial demands of homeownership;
- Borrowers who can be helped, and who were put into their current situation because they were victims of predatory lending, poor loan advice, or poor judgment on their own part; and
- Borrowers who can be helped, and were put into their current situation because of a change in their personal circumstances and now require payment flexibility to get back on their feet.

The next group of participants in the process is lenders. Within this group, there are generally two sub-groups: portfolio lenders and lenders who originated for sale into the secondary market. It is relatively straightforward to understand the interests of a portfolio lender that retains the credit risk associated with originating a mortgage. Lenders that originated for sale and expected to transfer credit risk may not have been as prudent in underwriting and assessing the ability of borrowers to repay.

The next group of participants is investors in the securitization. A typical securitization has a number of different investor types with differing risk profiles, return expectations, and interests in the securitization. For example, the investors in the highest rated tranches have agreed to take a lesser return and assume a lower risk profile in exchange for a more stable and predictable income stream. Next, the typical securitization will have mezzanine tranches held by investors who have a more elevated risk profile than the AAA (highest rated) investors, but who also expect a certain return on their investment in the securitization. Finally, there are the residual owners or investors, who bought into the deal with the understanding that they had the potential for significantly higher returns if the securitization performed as expected, but would take the first losses if the securitization did not perform as expected.

Next, we have the interests of the securitizers, as well as the trustee of the trust established to hold the mortgages pursuant to the securitization. While the interests of these two groups are not clearly aligned, both attempt to ensure that the best interests of the investors are served. While the trustee pursues this agenda with the understanding that it has a fiduciary duty to the investors, it is sometimes confusing to figure out exactly how this fiduciary duty may be served in protecting the interests of different types of investors in the securitization. In contrast, the securitizer will typically attempt to make sure that a securitization remains intact to avoid litigation exposure and potential tax and accounting issues arising from its initial actions in establishing the securitization.

Finally, perhaps the most complicated and complex interest in a securitization is that of the servicer, whose goal is to make sure the mortgage loans perform and payments are made to the mortgage trust based on the timetable established in the securitization. In effect, the servicer is the bill collector for the securitization. In this regard, the role of the servicer is critical to the success and continued viability of a securitization. For the same reason, the servicer also figures prominently in any efforts to prevent foreclosures of mortgage loans held by the trust, including loan modification and loss mitigation efforts to keep borrowers in their homes. Providing proper financial incentives and/or aligning the interests of the servicer with the other parties in a securitization is, we believe, key to the success of any foreclosure prevention or loss mitigation program.

B. Loan Modifications and Workouts

1. Supervisory expectations and available data

The OTS has consistently encouraged regulated institutions to work constructively with borrowers whose mortgage loans are in default or for which default is reasonably foreseeable. We continue to stress that prudent workout arrangements, conducted in accordance with safe and sound lending practices, are generally in the long-term best interest of both borrowers and lending institutions.

As part of our ongoing efforts, we recently held a national telephone conference with our examiners concerning supervisory expectations for troubled debt restructurings by our institutions. Pursuant to effective credit risk management procedures, institutions should work with borrowers to alter repayment terms, reduce interest rates, forgive principal, or take any other steps appropriate to protect the borrower and the institution. When modifying or restructuring existing credits, it is incumbent on an institution and our examiners to ensure that restructured loans are properly identified, risk rated, accounted for, and reported to preserve the accuracy and integrity of financial statements. Loan modifications that are not properly accounted for will have the effect of masking delinquency and nonaccrual levels, which could lead to inaccurate loss reporting and allowances for loss calculations. While proper accounting for a troubled debt

restructuring will have an impact on an institution's bottom line, it can be a significantly less costly alternative to foreclosure.

Many mortgages are held in securitization trusts that have outside servicers to manage the cashflows arising from the underlying mortgages. Most loan servicing agreements have been structured under the assumption that loan modifications are rare and would be pursued on a case-by-case basis. Generally, delinquent loans can be modified under this approach if the borrower demonstrates a willingness and ability to repay the loan under modified terms and it is in the best interest of the investors to modify the loan rather than foreclose. However, a loan-by-loan evaluation is very time consuming. With the rate of delinquencies in the mortgage market and the impending payment resets of various ARM products, there is little time for this type of in-depth loan-by-loan analysis. There have been a number of initiatives proposed to address this problem.

To date, there has been support for private sector initiatives to develop and implement a streamlined plan, such as articulated in the American Securitization Forum's December 2007 statement of principles on this issue and the efforts of the HOPE NOW alliance, a private sector group comprising about 84 percent of subprime lenders. HOPE NOW programs include a streamlined approach that would allow approximately 1.2 million subprime borrowers to be fast-tracked into affordable refinanced or modified mortgages.

Eighteen participating HOPE NOW loan servicers, covering almost two-thirds of the industry, provided loan modification data in January 2008. HOPE NOW reports that for July 1, 2007 through January 31, 2008, these participants completed over one million loan workouts—including almost 650,000 for subprime borrowers. About three quarters of the workouts were repayment plans, and one quarter were loan modifications. The number of loan workouts during that period was nearly three times the number of completed foreclosure sales.

Building on the HOPE NOW Alliance reporting template, OTS has begun the process of collecting extensive loan level data from its six largest mortgage servicers, who collectively service more than $2.5 trillion in first lien mortgages, on their loan modification efforts. With this data, we will be able to assess the progress being made in this area, as well as the relative success over time of different loan modification strategies.

2. Issues and Obstacles

While private sector programs are the lynchpin to the success of troubled debt restructurings, there are also important roles for policymakers, consumer advocates, academics, and individual borrowers. Engaging all of these parties, along with industry

players, is the key to resolving troubled mortgage loans. It is with this in mind that the OTS proposed its foreclosure prevention plan, discussed below, on ways to prevent avoidable foreclosures of underwater mortgage loans.

Initial data suggest that loan modifications are more difficult to accomplish than we might have wished. For example, HUD recently reported that more than 116,000 loans have closed under the FHASecure program since it was launched in September 2007. However, only a small number of these FHASecure loans (1,500 of them as of March 9th) were made to refinance delinquent conventional loans. Thus, so far, FHASecure has not contributed significantly to putting distressed homeowners into mortgages they can afford. One of the most important considerations in structuring a viable loan modification program is reaching as many borrowers as possible, as quickly as possible. In our view, this translates into conducting an expeditious and systematic review of outstanding loans approaching reset -- or for which a rate reset has already occurred -- to identify broad categories of borrowers eligible for loan modifications. As simple as this concept sounds, in application it has many challenges. I believe it is critical in this effort to provide servicers with as much guidance and flexibility as practical to conduct meaningful reviews to identify borrowers in need of assistance.

In structuring a viable loan modification program, three goals should be recognized and incorporated. First, and most fundamental, the program should preserve and sustain homeownership. Second, of course, the program should protect homeowners from avoidable foreclosures due to interest rate resets. Finally, it is extremely important that the program be structured to preserve and maintain market integrity, as well as ensure the continued safety and soundness of depository institutions and the broader financial services industry.

Currently, about 1.3 million American families have subprime 2/28 and 3/27 mortgages that are scheduled to reset by the end of 2008. The initial "starter rate" for these loans typically ranged from 7 percent to 9 percent. About 30 percent of delinquent 2/28 and 3/27 loans were past due before the rate reset. Between 1980 and 2000, the national foreclosure rate was below 0.5 percent of aggregate mortgage loans. As recently as 2005, the national foreclosure rate stood at 0.38 percent. Since then, the foreclosure rate has risen 55 percent to almost 0.6 percent of outstanding mortgage loans. Far more troubling is that, among subprime borrowers holding a 2/28 or 3/27 loan product, foreclosures are projected to continue to rise.

There are several important factors in structuring a viable loan modification program that could lower these projections. First, as I noted at the outset, expediency is critical. Servicers should quickly review their loan portfolios to identify characteristics of groups of borrowers eligible for loan modifications. Eligibility standards will determine the likelihood of achieving meaningful impact under a loan modification program. Generally, borrowers should be eligible if, due to rate resets, they are either in default, or there is a reasonable foreseeability of default.

A program's success will also hinge on providing adequate time for troubled borrowers to work out of their current economic problems. We believe servicers should be prepared to extend the starter rate for five years. And it may also make sense to include a trial period, such as six months, for certain borrowers to be able to demonstrate that they can continue to pay under the starter rate before the starter rate is locked in under a loan modification. Generally, a trial period will serve to protect the interests of the lenders, avoid including in a modification program loans that are destined to fail, and provide resolution to borrowers rather than delaying the inevitable.

We are aware of a number of loan modification programs that have already been established. While these programs generally have been in place for short periods of time, i.e., several months, it is our understanding that strategies similar to those articulated above have been successfully deployed to modify significant numbers and dollar amounts of subprime 2/28 and 3/27 loans held in securitizations. For example, several programs have employed broad-based borrower identification criteria to identify groups or classes of loans at risk, and then applied established eligibility requirements to hone in on individual loans and borrowers at risk of default. Other programs have opted for more individualized fixes by identifying borrowers and re-underwriting with full documentation for a 30 year term. We support all of these programs and efforts to address the problem and encourage any standards or guidelines that provide maximum flexibility to servicers and lenders to address troubled subprime loans in a manner that protects both the borrowers and the underlying economic interests of investors.

It is also critical that our actions preserve the integrity of the broader mortgage markets, including capital market participation in the continued funding of the mortgage markets. While some have suggested that previous actions of the capital markets fueled speculative and unsafe mortgage lending activities, there remain many U.S. consumers who are homeowners solely because of favorable mortgage rates and terms that they received as a result of the efficiency of the U.S. capital markets. We must take great care that our efforts on behalf of some consumers who entered into bad deals do not compromise the greater, collective interests of all consumers. It would be a policy failure to produce a result that alters mortgage funding so that the future cost or availability of mortgage credit is adversely affected for all U.S. consumers.

We are currently at what can best be described as a crossroads in addressing the combined effects of reduced home prices and the next wave of rate resets for subprime 2/28 and 3/27 mortgage loans. Despite a decline in interest rates, foreclosures among subprime borrowers holding these types of mortgages are expected to rise. There are a number of programs that have been reasonably successful in structuring viable loan modification approaches, but more needs to be done -- and soon.

As recently reported, there have been significant industry efforts to structure guidelines for viable loan modification programs that can be implemented quickly, efficiently and effectively in the marketplace. Our understanding is that many of the

issues previously identified as significant obstacles to broad-scale loan modifications may, in fact, be issues that can be addressed within the terms of the pooling and servicing agreements that dictate the rights of servicers and impact on investors under terms of the trusts that hold the securitized assets. Given this, we believe legislative and/or regulatory actions that are not carefully crafted could hinder rather than help at this point in the process. Therefore, we continue to encourage the industry to identify and implement solutions that work, with the full understanding that legislative intervention may occur if it becomes clear that any proposed solution(s) will not be effective.

IV. Further Foreclosure Prevention Initiatives

In addition to providing relief to distressed borrowers and avoiding potentially significant losses to security holders, foreclosure prevention is attractive to the broader economy because of the stabilizing effect it could have on the housing markets. There are numerous challenges and considerations in formulating viable foreclosure prevention initiatives that have sufficient reach to provide relief to distressed borrowers, as well as a meaningful impact on the existing housing economy. These include:

- Who is covered (e.g., distressed borrowers in owner-occupied properties)?
- Is the plan appropriately calibrated to assist borrowers unable to pay rather than those unwilling to pay (and should a plan address the latter issue)?
- Will the plan prevent foreclosures, rather than forestall eventual foreclosures?
- Should there be a different foreclosure prevention approach for loans held in securitizations versus loans held in portfolio by insured depository institutions?
- Are appropriate market incentives and borrower incentives maintained?
- Can the plan be implemented "operationally" by servicers to reach a sufficient number of borrowers on a wide scale basis, but only those borrowers intended to be covered by the plan?
- Does the plan protect servicers and trustees from potential lawsuits by disgruntled investors?
- Should investors fully absorb losses generated by the irresponsible behavior of borrowers, mortgage brokers and others in the mortgage loan process?
- What role should the government play in the process (including, whether the government should back borrowers and/or investors in the process)?
- What are the appropriate economic incentives for investors, borrowers, servicers and the government in a foreclosure prevention plan?
- What other tax and/or accounting issues present obstacles to implementing a viable foreclosure prevention initiative?
- What is the potential long-term impact of the plan, both on the direction of the current housing market and future financing and investment by the capital markets in housing?

These are key questions and the list is not exhaustive. Given the competing interests and concerns, some suggest that the best way to address the current problem is simply to let market forces prevail. Would this work? Ultimately, yes. But it would not be beneficial to permit that to happen. There are responsible "would-be" homeowners who chose not to enter the high-risk housing market of the past several years. What they and everyone else would gain by allowing unaided market forces to sort out the current mortgage market crisis would be perhaps even lower housing prices than in recent months, but this would be offset by significantly higher financing costs and uncertainty in the mortgage and capital markets over the long run.

The impact of the current market situation on mortgage lending and financing has been clear during the past several months. Subprime lending virtually dried up in many parts of the country and, until recently, even the lowest risk jumbo loans have been hard to find at rates remotely competitive with conforming mortgage loans. Both of these types of loan products have been historically funded to a significant extent by the capital markets.

Recently, government initiatives have supplanted the role of the capital markets in some areas by providing relief in the form of additional funding by increasing the conforming loan limit for loans purchased by Fannie Mae and Freddie Mac, as well as the loan limit for loans guaranteed by the Federal Housing Administration (FHA). In addition, the Office of Federal Housing Enterprises Oversight (OFHEO), which regulates the GSEs, recently eased the portfolio limits on Fannie Mae and Freddie Mac, and also reduced by one-third an OFHEO-directed capital surplus requirement imposed on the GSEs. All of these initiatives will increase the ability of the GSEs and the FHA to make mortgage loans, particularly in the jumbo loan market.

Thus, we already have witnessed a relatively robust government response to encourage new lending, along with other quasi-governmental initiatives to prevent foreclosures. However, more needs to be done to address preventable foreclosures. In particular, I believe the benefits of foreclosure prevention are very real and extend far beyond the immediate impact on distressed borrowers and holders of mortgage loans facing foreclosure. This is perhaps the most important aspect of the current foreclosure problem. While a "bailout" of irresponsible borrowers, lenders and investors is not appropriate, it may be appropriate to properly align incentives to protect those who otherwise acted responsibly or were victimized during the past several years. I believe tailoring a solution for this aspect of the issue is in our collective best interest.

It is with this backdrop and pursuant to your request to me a few months ago, Mr. Chairman, that the OTS developed its Foreclosure Prevention Proposal. As you know, the OTS regulates an industry comprising mostly mortgage lenders. Thus, we have extensive experience in aspects of the mortgage markets, including lending, funding and consumer protection issues. In developing our proposal and in fine-tuning it, we have

met with many stakeholders in the mortgage market in an attempt to identify potential pitfalls, and to understand incentives and disincentives at work in the marketplace. In that process, we have learned a great deal about the difficulties that any attempt to address foreclosure prevention will face. Crafting a solution to the current foreclosure challenge requires extreme sensitivity to all of these constituencies, as well as other competing interests. I know that you are extremely familiar with these issues given your own legislative efforts to address the problem. In this regard, you have asked for our thoughts on your proposal, the FHA Housing Stabilization and Homeownership Retention Act of 2008 (the HSHR Act).

A. Overview of the HSHR Act

Based on our review of the major provisions of the HSHR Act draft, it would require the FHA to guarantee up to $300 billion in new mortgages to refinance existing eligible mortgages originated between January 1, 2005 and July 1, 2007 on owner-occupied properties at risk of foreclosure. The proceeds from the new FHA-guaranteed loan would be used to pay off existing lenders or mortgage holders after write-down of the existing loan to an amount approximately equal to 85 percent of the current fair market value (FMV) of the property. In this regard, the loan-to-value ratio of the new FHA-guaranteed loan cannot exceed 90 percent of the current FMV of the property and there is an additional 5 percent of FMV fee payable to the FHA at origination of the FHA-guaranteed loan. This effectively brings the amount payable to the original loan holder down to 85 percent of the current FMV of the property (with no recovery of other prepayment penalties or default/delinquency fees).

In addition to the 5 percent FHA origination fee, the borrower is obligated to the FHA for an exit premium payable upon sale or refinance of the property in an amount equal to at least 3 percent of the original FHA-guaranteed loan. However, for a sale or refinance during the first five years after origination of the FHA-guaranteed loan, the exit premium is equal to the greater of the 3 percent fee or a decreasing percentage of profits from the sale (100% in Year 1, with a 20% reduction in each subsequent year down to 20% in Year 5).

To be eligible for a new FHA-guaranteed loan under the proposal, borrowers must have a mortgage debt-to-income ratio of greater than 40 percent and must certify that they did not intentionally default on their original mortgage loan. And, as highlighted above, the original loan holder must agree to accept an amount equal to 85 percent of the current FMV of the property, with no prospect of additional recovery regardless of the future performance of the underlying collateral.

A final provision of the draft that I want to highlight is a proposed mechanism for the bulk refinancing of existing loans. It is our understanding that this provision is

intended to establish an auction procedure that may or may not be utilized depending on the overall state and stability of the housing markets. While we appreciate the concept of establishing such a mechanism for the bulk refinancing of existing distressed mortgages, the parameters of the program are not entirely clear to us. Of particular concern is the possibility that such a mechanism could further depress housing prices rather than stabilize them. At this time, we withhold any additional comment on the bulk refinancing auction mechanism until we have a better understanding of the intent and application of the provision.

B. Comparison to the OTS Foreclosure Prevention Proposal

The OTS Foreclosure Prevention Proposal (copy attached) is also intended as a mechanism to aid the growing number of borrowers who will find themselves in financial difficulties because their mortgages are "underwater." It is not a "silver bullet" that will provide a single solution to the current crisis. There is no single solution. The intent of our proposal is to provide another meaningful tool to add to the options available for foreclosure prevention and revitalization of the mortgage market.

The OTS proposal has a number of similarities to the HSHR Act draft, including reliance on the FHA to guarantee new loans to replace existing loans held by distressed borrowers in owner-occupied properties. This is a key concept that enables the leveraging of existing governmental resources in a meaningful partnership with private lenders. Ensuring that new FHA-guaranteed loans are based on the current FMV of the property is also a key common element of the proposals. Finally, using the proceeds of the new FHA-guaranteed loan to pay existing loan holders via a short sale or partial pay-off to extinguish their existing mortgage position is also a common element of the proposals. This would provide a significant new tool to servicers and lenders seeking to avoid preventable foreclosures. However, the way this is accomplished is different under the HSHR Act draft and the OTS plan.

First, under the OTS plan, the intent is to provide a negative equity position to the original loan holders in an amount equal to what they are giving up by taking the partial pay-off or short sale from the proceeds of the new FHA-guaranteed loan. This is intended to recognize that the FMV of the underlying real estate collateral may eventually be restored back to its original valuation and that the original lender or loan holder should get the benefit of that appreciation up to the amount originally extended to the borrower. This would also avoid the situation of a future windfall to borrowers whose debt is written down and the value of their home returns in several years to the original loan amount (or more) upon sale of the property.

The HSHR Act draft would prevent a potential windfall to an existing borrower to a more limited degree. The HSHR Act draft would enable a borrower to recoup the entire gain on the sale of the property after five years. In contrast, the OTS proposal does

not provide a time limit on recovery in a subsequent sale, only a dollar limit on recovery equal to the amount of the initial shortfall. While we acknowledge that it makes sense for a borrower to have an incentive to preserve property value and to maximize proceeds from a future sale, we do not believe borrowers should be absolved outright of their prior obligation. The OTS proposal does provide a borrower incentive by allowing the borrower to keep the sale proceeds in excess of the amount due to the original loan holder.

Fundamental to the OTS proposal is the underlying premise that most real estate values tend to increase over time. Assuming this is true with the properties held by many currently distressed borrowers, such borrowers could reap a significant future windfall if they are permitted to retain profits from a future sale rather than making the proceeds available to pay off the remaining amount of their original obligations, which would effectively now be provided to them interest free.

Another important difference between the OTS proposal and the HSHR Act draft is that the OTS proposal would provide to the original loan holders as much of the current FMV of the property as is feasible for a new lender to extend under a FHA-guaranteed loan to minimize the shortfall in the original loan obligation. In contrast, while the HSHR Act draft has a comparable target as envisioned in the OTS plan of issuing FHA-guaranteed loans at or around 90 percent of the current FMV of the property, the draft would impose an additional fee payable by the original loan holder. This fee, equal to 5 percent of the current FMV of the property, would be absorbed by the original loan holder as a reduction in the proceeds payable to the holder. While we understand the merits in imposing this fee may be important, it may make sense to transfer its cost to the borrower that is getting the benefit of the new FHA-guaranteed loan, for example, by tacking the fee onto the back end of the transaction and making it collectible at the time of the subsequent sale of the property. This would still diminish negative equity, but not the upfront short sale payment to the original loan holder.

In sum, Mr. Chairman, the OTS proposal differs from the HSHR Act draft in two important respects. First, it results in less of a shortfall to existing loan holders, which we believe is important to minimize the negative impact on market forces and create incentives for loan holders to participate in the program. We think the key to success for this approach is for the loan services to have enough incentive—through a stake in the future upside potential—to be moved to action to save the home from foreclosure. If the servicer, acting on behalf of the original loan holder, does not have sufficient incentive, then no action will be taken, more homes will be lost to foreclosure and this crucial foreclosure prevention effort will fall painfully short of its mark. In this regard, we would note that the negative equity interest created under the OTS plan has the potential to be shared among existing lien holders, the FHA or other insurer, and the original borrower in whatever manner best aligns their interests to facilitate a foreclosure prevention solution.

Second, the OTS proposal holds existing borrowers to a significantly higher degree of accountability for their past actions. Again, we think this is a highly desirable result from a public policy standpoint. We must remember that while the number of problem loans is large, over 93 percent of homeowners continue to pay their mortgages as agreed, and over 93 percent of mortgages held by the thrift industry are paying as agreed.

For these reasons, Mr. Chairman, we continue to believe that the merits of the OTS proposal – subject to further refinements, including improving borrower incentives to optimize future sale value, should be considered as part of any foreclosure prevention solution. As I stated before, the OTS proposal is not a panacea, but a tool that lenders can use to stem the rise in foreclosures, and we have been encouraged to continue to develop the plan.

V. Conclusion

Thank you, Mr. Chairman, Ranking Member Bachus, and Members of the Committee, for the opportunity to testify on behalf of the OTS on the HSHR Act and foreclosure prevention.

We believe that foreclosure prevention efforts that keep distressed borrowers in their homes by partially paying off their current "underwater" mortgages with an FHA-insured loan and allocating the balance to a negative equity interest offer the best option to reduce preventable foreclosures. A negative equity interest that would pay out in the event of future appreciation upon sale of the property can be apportioned to allow incentives to be aligned in a way that that will maximize the number of foreclosures prevented.

We look forward to working with the Committee to address the continuing challenges in the mortgage markets, and in fashioning a strategy to limit needless and preventable foreclosures. Thank you.

Office of Thrift Supervision Foreclosure Prevention Proposal

Problem: Avoiding foreclosures of owner-occupied properties held in securitizations where a distressed borrower is unable to refinance a loan because the fair market value of the property is less than the current outstanding loan amount.

Objectives:

- Identify a market-driven solution that relies on existing programs, avoids a new government guarantee or assistance, and does not result in the transfer of unacceptable risk to an insured depository institution's books.
- Ensure that the solution minimizes motivations for "gaming" the system by borrowers currently able to pay under their existing loan.
- Avoid providing a windfall to borrowers and investors in the securitization.
- Identify a solution that optimizes investor incentives/motivations to seek it out and maintains borrower incentives to preserve the value of the property.

Solution: Implement a program where:

- Depository institutions offer and underwrite FHA-insured loans based on a percentage of the current fair market value of the property (e.g. 90 percent);
- Proceeds of the new loan are used to provide a partial pay-off of the outstanding balance of the original mortgage loan to the holder of that loan; and
- Existing holders of the original loan receive a "negative equity interest" equal to the difference between the partial pay-off and the balance of the original mortgage loan held by the securitization pool. Alternatively, the negative equity interest could be shared among the existing loan holders, the FHA (or other entity protecting FHA's insurance risk), and/or the borrower/homeowner as needed properly to align incentives.

Pursuant to the program:

- The proceeds of the new FHA-insured loan would be used to pay off the original loan at a discounted payout (i.e., less than the original outstanding loan amount).
- The original loan holder would receive a negative equity interest (as a non-interest bearing second position claim) equal to the amount of the discount between the new FHA loan and the unpaid balance on the original mortgage (however, this amount could be reduced by a designated percentage, e.g., 15 percent, which would be paid to the borrower upon sale in order to maintain incentives to preserve the property and maximize its value at sale);
- Upon a later sale of the property by the borrower, any appreciation in the value of the property (reflected in the sale price) above the discounted payout (i.e., the amount paid to the original loan holder with the proceeds of the FHA-insured loan) would be payable to the holder of the negative equity interest up to the full amount of that interest (less any borrower offset to preserve the value of the property), with any sale proceeds beyond that amount accruing to the borrower.

4/8/2008

Justifications/Rationale:

- Provides a market-driven solution that does not "bail out" investors or borrowers.
- Designed to maximize the servicer's recovery of proceeds from the distressed borrower.
- Requires the original loan holder to take a lesser amount when the FHA loan closes, but not a dramatically reduced recovery such as that in a foreclosure of the original loan. This provides an incentive for the original loan holder to participate in the program.
- Avoids a windfall to borrowers by requiring any appreciation in a subsequent sale be paid to holders of the negative equity interest up to the amount of the discount that the original loan holders took when the original loan was cashed out (less any borrower incentive to maintain and maximize the value of the property).
- Relies on an existing framework – including the FHA-insurance – for addressing problem loans in securitizations.
- Creates a potentially marketable financial instrument in the negative equity interest.
- From a tax standpoint, this approach is neutral given that it does not involve forgiveness of debt because the borrower would still be on the hook for upside appreciation and the amount of loss would not be determinable until subsequent sale of the property by the borrower.

Example:

- $220,000 subprime mortgage loan extended in March 2006 on residential property then appraised at $240,000.
- Distressed borrower facing reset in May 2008 that will significantly increase the monthly mortgage payment; borrower will have difficulty making the payment at the reset amount.
- Fair market value of the property is now at $200,000.
- Borrower informs servicer of borrower's financial distress pursuant to inquiry by servicer about the borrower's ability to make the new (reset) payment.
- Servicer refers borrower to FHA-insurance program at ABC FSB that will make a mortgage loan to the borrower at 90 percent of the current fair market value of the property (i.e., a $180,000 mortgage loan).
- Servicer agrees to take $180,000 partial pay-off in order to remove the existing subprime mortgage from the securitization pool, while restructuring the original loan and subordinating its position through retention of a $40,000 negative equity interest that would be payable out of any appreciation in the value of the property (i.e., sale proceeds exceeding $180,000) from proceeds of the future sale of the property by the borrower (and offset by any borrower incentives, e.g., 15 percent of excess proceeds, to preserve/maximize value of the property).
- Borrower has $180,000 FHA-insured fixed interest rate loan with affordable monthly payment; and investors hold a non-interest bearing $40,000 negative equity interest (less any borrower offset) in the property (i.e., a "zero-interest/coupon" second mortgage).
- If borrower sells property in 18 months at a sale price of $236,000, the first $40,000 of the $56,000 difference (appreciation) between the sale price and the refinanced loan amount is payable to the investors (with a percentage to the borrower as an incentive, if applicable) on their negative equity interest in the property.

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The Housing and Financial Crises, the Economy, and Public Policy Choices

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Statement prepared for The House Committee on Financial Services Hearing on "Using FHA for Housing Stabilization and Homeownership Retention," House of Representatives, 2128 Rayburn House Office Building, Wednesday, April 9, 2008.

The Housing and Financial Crises, the Economy, and Public Policy Choices

by Allen Sinai*

The Housing and Financial Crises

After six years of economic expansion fueled by a boom in housing and in consumption, a corresponding boom in mortgage debt, credit and debt generally, and the volume of business done by an increasing number of bank-like financial intermediaries, the U.S. economy has fallen into a recession.

The housing boom is now a bust, a housing asset price bubble that accompanied the boom has burst, and all that had been built on the edifice of residential real estate and derived from U.S. housing has come tumbling down in the inevitable unwinding of the housing, housing finance, and speculative boom. Housing construction, housing finance, the levered financial instruments that were created and financial intermediaries, bank and nonbank, for which so much risk-taking and business was created are in recession or some sort of financial distress. Residential real estate as asset collateral for the debt and credit of lenders and borrowers—the "darling" of almost all as *the* asset of choice—and any debt derivatives or equity paper have become a "pariah."

Unfortunately, the declining values of housing and housing credit, negative impacts on the financial system, on consumer confidence, household wealth and the inability of consumers to draw on home equity for various purposes are continuing, contributing significantly to the recession and associated financial fallout. Declines in the values of stocks of companies and financial institutions involved in the housing boom also are continuing as all firms, financial institutions and households, directly, and indirectly tied to housing remain at considerable risk. The balance sheets of financial intermediaries are contracting and a number of them have sought new capital or failed. Credit within the financial system, financial institution-to-financial institution, has been difficult to obtain. And, a "run" on one financial institution, Bear Stearns, brought a managed failure to that situation. Additional failures remain possible, although more likely a matter of insolvency rather than illiquidity with the opening of the Federal Reserve discount window to Primary Dealers. The chances of an accident on liquidity bringing down a major financial institution are now much less.

Housing, Housing Finance, and the Economy—The Economy and Housing

As a consequence of the housing downturn (Table 1) and other factors the U.S. economy is in recession, the U.S. housing sector and U.S. financial system are in crisis, and taxpayer funds have been put at risk by the central bank and federal government, but still with an outcome that is not clear.

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Ripple effects from the housing collapse and U.S. economic downturn are reverberating through financial markets, credit, balance sheets, into the global economy, along with a growing risk of global recession. On recent economic data, the U.S. recession is deepening and widening, with an increasing array of key monthly economic indicators showing flat or declining activity. This includes increased jobs losses, a rising unemployment rate, flat to negative real retail sales and real consumption, a manufacturing recession as indicated by Purchasing Managers' Surveys, cutbacks in business production, inventories and capital expenditures, and threatening financial situations for a large number of states. Although real GDP has not been negative yet, this matters little given the economic weakness being shown in so wide a range of monthly data and on the anatomy and process of the recession as it unfolds.

The housing bust and biggest declines ever in published data on home prices (Table 1), the effects on consumer confidence and spending, the inability to draw on rising equity in homes, negative effects on business sales and profits, collapse of subprime and other credit, exposures in U.S. and other financial intermediaries to a huge amount of mortgage-related debt and weakened collateral values of newly created financial instruments, and now balance sheet contraction across a wide range of financial intermediaries can make the economic downturn, currently in its early stages, a severe one.

Housing was a major lever for the boom and now is a major lever for the economic downturn. As consumers and businesses cut back, the unemployment rate rises and rest-of-the-world economies slow in response to a weakened U.S. economy, the demand for housing and mortgage finance, already extremely depressed, could worsen even more, bringing second and third round negative effects for housing, credit, the U.S. economy, U.S. financial institutions, and the global economy.

The fallout on the economy and financial system from the housing downturn, declines in housing prices and in the value of real estate asset collateral, the burden of outstanding debt and interest payments on the debt, especially in a recession with rising unemployment, is very substantial. Defaults, delinquencies, foreclosures and bankruptcies related to housing are at record levels with credit tight or not easily available, within and outside of the financial system. Empty homes and distressed sales are numerous. Many individuals who might otherwise be able to afford payments on their homes cannot. Many financial institutions that had exposure to housing and housing finance are out of business or suffering losses. The new leveraged financial instruments which had become the source of large fees and commissions for many investment bank/brokerage firms and financial services providers no longer are so. And, the values of mortgages, mortgage-backed securities, collateralized debt obligations, mortgage derivatives in whole or in part, and other instruments that used rising prices

on residential real estate as underpinning have collapsed, bringing a sizeable contraction in balance sheets and need for capital by many financial intermediaries, bank and nonbank. Some capital is being provided by Sovereign Wealth Funds (SWFs); some from pools of capital at other institutions or from investors.

Public Policy Choices

With all that has transpired, the U.S. financial system is very much impaired, if not broken; so is housing. Public policy choices must be made beyond those so far to cushion and prevent a further cascading of effects and even more of a cumulative downturn than has already occurred.

What might these choices be?

Certainly, in the U.S. low interest rates are a necessary condition to floor and reverse the downturn in housing and in credit. Interest rates, both short- and long-term, are a fundamental determinant for the valuation, or price, of housing. Recently, the Federal Reserve has moved quickly and resolutely in this direction. More interest rate reductions are likely. In principal, there is *some* low level of interest rates that could stop the declines in housing prices that are at the heart of the housing and financial crises. In some fundamental sense, low interest rates, under normal circumstances, can stop the declines of housing prices that are taking down the value of housing as collateral and as a source of ultimate value in so many derivative financial instruments and for those financial institutions whose balance sheets and businesses are tied to it.

But with the negative price dynamic of a bursting asset price bubble, the psychology associated with declining house price expectations could well overwhelm the fundamental help that lower interest rates provide. A huge overhang exists in the supply of housing and in mortgage finance instruments, relative to demand, suggesting that downward price pressure could continue for quite some time to bring additional declines in the values of housing asset collateral, rising debt-to-asset ratios for households, and continuing compromise in the balance sheets of households and those firms and institutions whose balance sheets, directly or indirectly, are tied to residential real estate.

A second choice, or line of defense, is aggregative fiscal policy measures such as tax cuts or increased government spending. The fiscal policy stimulus recently passed by the Congress and signed by the President provides one-time tax reductions to households and businesses. Although these may serve to cushion the overall economy from the consequences of the housing downturn and ongoing financial distress, they cannot get at the root cause of the housing and financial crises, which is too much available housing, too little demand and too large a supply of mortgage debt, mortgage derivative securities, and structured investment vehicles relative to the demand. There is a

considerable amount of weak collateral, a lot of impaired investments, and a huge overbuild in housing. The negative housing and credit shock is reverberating through the economy as are the associated financial consequences. Unfortunately, the tax reductions are too small per household to deal with monthly payments that are basically unaffordable at newly reset mortgage interest rates and reduced home appraisal values. And, unfortunately, these tax reductions are only temporary. Any help likely will come from what initial surveys suggest, that much of the tax cuts will not be spent but instead used to save or pay down debt. Decision Economics, Inc. (DE) quantitative research shows that *permanent* tax reductions have triple the power for the economy and household spending compared with *temporary* tax cuts of the same magnitude.

Third, there are measures in the public policy arena involving the federal government or central bank that could be taken.[1] These can involve, directly or indirectly, risk to taxpayers' monies, and raise concern over moral hazard. But, taxpayer monies likely will be lost anyway, if only because of the lost federal government tax receipts from an economic downturn. Spending *some* taxpayer monies now to preempt and prevent a further cumulative downturn can be preferable, depending on how government funds are used and what conditions might be put on their application.

A fourth choice is to do nothing. Politically, this is virtually impossible in the current situation. For many Americans, owning a home is a lifetime dream and the value of their house is much, if not all, of family net worth. With so many abuses and so much laxity in supervision over what went on in housing, housing finance, subprime lending and borrowing, and the huge payouts to executives and workers in many financial intermediaries such as private equity firms and mortgage lending entities, the taxpaying public is justifiably enraged. Indeed, the unhappiness is such that public opinion is very much against *any* help at all to institutions such as Bear Stearns, or individuals who took on so much risk and where so many earned so much.

But, this is short-sighted! Doing nothing is essentially what happened in the early 1930s. A hands-off attitude by government and the central bank was a major contributor to the Great Depression. Doing nothing can be a roll of the dice—risking the unknown effects of serially correlated

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[1] Many already have been taken. FHA-insured loans now can be as high as $729,750, compared with $417,000 before. The Federal Home Loan Banks (FHLBB) have been authorized by the Federal Housing Finance Board to make investments in mortgage-backed securities up to 600% of capital compared with 300% previously. Capital surplus requirements have been reduced for FNMA and the FHLMC, permitting many more conforming mortgage loans to be insured. And, the conforming loan limit for loans insured by FNMA and FHLMC also has been raised to $729,750. These measures ultimately involve taking some risk with taxpayer money, as well as increasing the moral hazard from the explicit or implied increased government insurance.

The Bush Administration initiated the FHA Secure refinance and Hope Now Alliance freeze programs and may support some of the other initiative to help housing.

negative consequences in the financial markets, for financial institutions, and for the economy. Indeed, although ultimately, in theory, downturns in the economy and finance can be self-correcting, in practice this is not easily possible with losses along the way and unintended consequences potentially extremely severe and even possibly irreversible.

In the public policy arena, one question is the risk and uncertainty of one action versus another, i.e., the costs versus the benefits of alternative actions as best can be seen at the time. Leaving housing alone and doing little, or nothing, through the potential role of the federal government defeats one of the purposes for the federal government which is to be a source of support in times of stress. Economic security is really not so different from military security in terms of potential negative effects on the economy and the lives and well-being of Americans.

The declines in housing and in home prices, although from unsustainably high levels that admittedly were driven by considerable aggressive and irresponsible risk-taking and lax regulation and supervision, does not mean that the "casualties of capitalism," either individual households or, in the aggregate, the economy itself through an economic downturn, and then as a secondary effect, losses of jobs and incomes, should not be supported, or cushioned, by judicious and efficient use of public money and federal government intervention.

Frank-Dodd Initiative—Minimal Taxpayer Funding at Low Risk for Potentially High Returns and Homeowner Retention

One of the public policy measures to consider is the proposal of House Financial Services Committee Chairman Barney Frank and Chair of the Senate Banking Committee, Christopher Dodd.

This potential legislation would use the Federal Housing Administration (FHA) to help stabilize housing and to facilitate homeownership retention and has considerable promise, risking little in taxpayer monies for a potentially large volume of refinanced and restructured mortgages insured by the FHA and tailored to the affordability profile of qualified borrowers.

Borrowers could finance 90% of the *current* appraised value of the property on a well-underwritten FHA-lender approved loan at a market rate of interest that was evaluated as affordable.

Lenders would have to write down the remaining principal on the original mortgage loan to 85% of the *current* appraised value, but in return would receive this amount to pay off the original and discounted mortgage to another lender or mortgage-service provider. The lender would put 5% into an insurance reserve at the FHA. The borrower would pay a small insurance fee into the FHA. The government would retain a small lien on the loan.

In this proposal, lenders would do better by not having to deal with foreclosure or the refusal or failure of borrowers to make monthly payments. Borrowers would keep their home. The FHA-approved lender would take the loan, now reconfigured, restructured, and refinanced in a reasonable fashion.

Other conditions would be placed on the lenders and borrowers, including:

- only the principal residence, or first home, would be eligible;
- the existing loan being refinanced would have to be originated between January 1, 2005 and July 1, 2007;
- mortgage holders/investors/lenders would accept proceeds of the new loan as payment in full on the old loan;
- the write-down on current loans from current appraised values to no more than 85% of the property's current appraised value would have to be accepted by the original mortgage holders. The financial benefits from not having the costs of foreclosure on the loan and potential loss of principal would appear to be considerable;
- all loans guaranteed by the FHA would be subject to stringent underwriting standards and full disclosure of the financial position of the borrower;
- the government would retain a small second lien on the property so that when the borrower sold the home or refinanced the loan, an exit fee would be paid from any profits approximating 3% of the original FHA loan balance or a declining percentage of any profits.

The plan would also provide for $10 billion to $20 billion in loans and grants to states for the purchase and rehabilitation of foreclosed homes with a goal to occupy them as soon as possible.

This enhanced FHA program provides benefits to all, essentially some penalties to all, but retires poorly collateralized mortgage indebtness or mortgage-backed securities in return for a currently viable mortgage instrument for the borrower.

The program has considerable appeal and very likely would raise the demand for restructured and refinanced mortgages and reduce the volume of mortgage loans that were not viable under current housing market conditions. This is an essential element in clearing the market from an excess supply of weakly collateralized loans. So long as the financial system has large volumes of bad loans, credit restraint within and outside the financial system will persist.

Retaining homes rather than foreclosure or bankruptcy would reduce the supply of vacant homes for sale, helping to alleviate the overhang of inventory relative to demand, essential to

eventually floor the declines in housing prices. When housing prices stop declining, the crisis may be over.

The balance sheets of financial institutions involved in mortgage lending would be enhanced by the "swap" of badly collateralized mortgage or mortgage-backed product for new restructured mortgage loans that were well-underwritten. Mark-to-market values of the new stock of mortgage loans would be enhanced by the FHA guarantees which, in turn, would partially be financed by payments from lenders and from borrowers into an insurance fund reserve.

The estimated costs of the program are administrative, on the order of about $350 million with $10 billion borrowed by the FHA in order to provide funding through loans and grants to states for the purchase and rehabilitation of vacant, foreclosed homes and then a reoccupation of them. This part of the proposal would serve to remove housing supply from the market, helping to reestablish a balance between demand and supply and the ultimate solution for the housing crisis, the flooring of home prices and end to declining values of residential real estate and of the collateral backing so much of the mortgage finance products that are being utilized.

On a microeconomic basis, many homeowners, estimated at perhaps one million to two million, would benefit and be able to retain their homes. Lenders would end up with well-backed and better collateralized mortgages than previously. The government, at little cost, would have managed and intervened to achieve what negotiations between borrower and lender could not and all would be risking some equity but with a potential for gain upon recovery in the housing market and in housing prices.

The proposal does have considerable appeal. But, there are shortcomings.

First, to realize maximum benefit to housing, homeownership retention, and to the economy, lenders and borrowers still would have to apply and agree. This may not occur to the degree envisioned.

Second, the program would be limited to first homes only, leaving out quite a bit of distressed property, under-collateralized mortgage-backed securities, and mortgage weakness for those who have second homes. Not all vacation homes are speculative or unessential.

Third, the net of potential participants appears fairly low, constrained by the dates of mortgage origination that span only 2005, 2006 and 2007. Mortgage resets and restructuring could probably apply also to 2004 and 2008. Although the demand for mortgages and housing likely would increase and the supply of mortgages and housing diminish, price declines could still occur making the current

appraised values upon which the restructuring was based out-of-date some time in the future and mortgages that might still have negative equity, despite all of the actions taken.

Fourth, the macroeconomic effects, while probably noticeable, likely would be very small and not sufficient to diminish enough the supplies of housing and of mortgage-backed financial instruments that overhang housing and the financial system and are contributing to declining home prices and declining values of credit and debt. It is these declining values that are contributing to balance sheet contraction of financial institutions and tight credit availability.

However, as one approach of federal government action to intervene and cushion the fallout on housing and in mortgage finance from the housing bust and declining home prices, the Frank-Dodd proposal should be legislated and passed after further study and some modifications.

Some Concluding Perspectives

The U.S. economy is in a recession, with the proximate cause a housing downturn and bust after a huge boom and the bursting of a housing price asset bubble.

The severe downturn in housing and decline in housing prices have helped bring down aggregate consumer spending, some 71% of real GDP, in response to declining real household wealth, particularly in real estate and equities; the inability anymore to draw on rising housing equity through various forms of cash-out financing; through a lack of realized capital gains on housing; and through the damage to consumer sentiment from declining home values. The U.S. downturn now is centered on consumption and is being accompanied by derivative cutbacks in business hiring, business capital spending, in production and in inventories.

In addition, the collapse of mortgage credit, initially in subprime lending, and the declining values of financial instruments ultimately derived from and tied to the value of residential real estate have caused a contraction in the balance sheets of numerous financial intermediaries, a credit and balance sheet crunch that is restraining spending across-the-board.

DE quantitative research shows the propensity to consume cash-out financing, capital gains on housing, and household wealth to be quite sizeable—$0.26 per $1.00 of reduction in cash-out financing, $0.25 decline in spending on reduced capital gains realizations, and nearly a $0.06 decline ($0.03 to $0.05 for reductions in real net estate values).

Estimated declines in the volume of cash-out financing over the past year, approximately about $150 billion, in unrealized capital gains a fall of $200 billion, and reductions in real household wealth of nearly $500 billion. Lost growth in consumption spending is about one percentage point. Given the

lags and the effects for these determinants of consumption, the bulk of the negative effects is in train now.

The housing boom and rising home prices were a major source of the economic upturn in 2003 to 2006, but now are a major source for the economic downturn. In addition, the financial fallout from the housing declines, in activity and in prices, operating through a wide range of financial intermediaries, has imposed a negative credit and debt shock on the economy which is more than overwhelming the possible effects from the reductions of interest rates that have occurred in recent months.

A recession economy, rising unemployment, tight credit, and balance sheet contraction for financial intermediaries could reverberate back to depress further the demand for housing and reduce housing prices more on the continuing excesses of supplies relative to demands. A financial system clogged with badly collateralized mortgage and mortgage-backed debt will continue to be under pressure and as the recession plays out through other areas of credit could engender insolvency for some major financial institutions.

Housing thus is in crisis; so is the U.S. financial system. Herein lies a role for public policies to cushion, limit, and prevent a further intensification of the housing downturn and all that it might entail.

One such public policy is the Frank-Dodd proposals to restructure and refinance a considerable volume of mortgages whose reset would lead to foreclosure for borrowers that otherwise might be able to make payments on a more realistic loan with reduced principal.

The plan uses participation by lenders, borrowers, and an enhanced FHA to bring about, at little cost to the federal government, restructured finance that would permit qualified borrowers to make required payments and keep their home.

The outstanding principal on an existing loan would have to be written down and accepted by lenders to 85% of the current appraised value and a new loan made to a borrower for approximately 90% of the value for the housing collateral. The original lenders for the unsupported loan would take the new loan, underwritten to make sure that the borrower has the ability to pay, in exchange for the old loan at 85% of the new lower appraised value of the home. The five percentage point difference would be put into an FHA insurance reserve by the lender and the borrower would pay a small fee into the insurance fund. FHA could guarantee, or insure, up to $300 billion of mortgage loans in this manner, but better-qualified and safer loans than those held previously that probably would not be repaid at all on a foreclosure or bankruptcy.

The cost to the government would be administrative, estimated at $350 million to perhaps $500 million, and $10 billion-or-so in funds to be borrowed and channeled into states for use in buying-up foreclosed property. The substitution of good collateral for bad, the acceptance of a markdown in principal to be repaid by a lender or servicers, the lower loan-to-value ratio for the borrower, and the potential "skin-in-the-game" for all three participants makes this program shared risk and no bailout of anyone. The federal government role is as insurer of last resort and to facilitate the transaction and restructuring for lender and borrower, a proper function of the federal government. On subsequent gains in the value of housing, or losses, all participants would share to some extent. The ability of the FHA to insure a much larger volume of mortgages than the cost to the federal government makes this a highly leveraged use of government funding.

There are other possibilities involving a role for the federal government.

In 1991, the Reconstruction Finance Corporation (RFC) was established to sop up foreclosed property on the collapse that occurred in the savings and loan industry. The government bought up property and eventually sold it off into the market.

Currently, a new entity, or existing agency like the FHA, could directly purchase mortgages on which payments were insufficient and where the value of the underlying property was far less than the mortgage itself, restructuring the mortgages and reselling them to another institution in the private sector at a discount, or insuring new mortgage loans of lenders under the supervision of the agency, thus cutting the supply of bad collateral and increasing the demand for new, affordable mortgage loans tailored to the housing and mortgage market.

While this would be a more direct intervention by the federal government than enhancing the FHA, such an agency could seek capitalization from government funds and private sector funds from those institutions who stood to gain more on maintaining homeowners in their homes and restructuring mortgages rather than foreclosures, bankruptcy, or nonpayment of the principal or monthly payments on the mortgage loans.

Public policy and intervention by the federal government, long eschewed by free market proponents and many policymakers, certainly seems appropriate at times like this, where there are market failures, or crises, not easily handled by the private sector whose individual interests may not correspond to the public welfare at-large.

Table 1
Defining the Housing Boom/Bust
(2000-to-Date)

	Trough in 2000-2001	Date of Trough	Peak in 2005-2006	Date of Peak	Pct. Change from Trough	Trough in 2007-2008	Date of Trough	Pct. Change from Peak
Home Sales (1000s)								
New Single-Family	793	Jun-00	1389	Jul-05	75.2	590	Feb-08	-57.5
Existing Single-Family	4520	Dec-00	6340	Sep-05	39.4	4320	Dec-07	-31.9
Existing Condo and Co-op Sales	543	May-00	934	Jan-05	72.0	560	Dec-07	-40.0
Inventories (1000s, Ratio, %)								
New Homes Offered for Sale/Sales	0.384	Jun-00	0.287	Aug-03	-25.3	0.809	Dec-07	181.9
Existing Homes Offered for Sale/Sales	0.409	Jan-00	0.302	Jan-05	-26.2	0.853	Oct-07	182.5
Months Supply of New Homes for Sale	3.7	Feb-01	7.4	Jul-06	100.0	7.2	Jan-07	-2.7
Months Supply of Existing Homes for Sale	4.1	Dec-01	7.2	Jul-06	105.6	6.5	Jan-07	-9.7
Housing Prices ($s)								
New Single-Family Homes (Med.)	160,100	Jun-00	257,000	Apr-06	64.0	225,600	Jan-08	-14.1
Existing Single-Family Homes (Med.)	139,600	Jan-00	230,900	Jul-06	65.4	193,900	Feb-08	-16.0
Case-Shiller	100	Jan-08	206.52	Jul-06	106.5	180.65	Jan-00	-12.5
Housing Starts (1000s)								
Total Starts	1463	Jul-00	2292	Jan-06	56.7	1000	Dec-07	-56.4
Single-Family Starts	1142	Jul-00	1837	Jan-06	60.9	707	Feb-08	-61.5
Multi-Family Starts	281	Aug-01	455	Jan-06	61.9	218	Dec-07	-52.1
Employment Related to Housing (1000s)								
Manufactured and Mobile Homes	50.6	Feb-01	50.5	Apr-06	-0.2	34.9	Feb-08	-30.9
Residential Building	743.0	May-01	1037.3	Aug-06	39.6	835.7	Feb-08	-19.4
Furniture and Home Furniture Stores	533.4	Jul-01	611.6	Dec-06	14.6	562.4	Mar-08	-8.0
Building Material & Garden Equipment & Supplies Dealers	1076.0	Jan-00	1389.3	May-06	29.1	1204.9	Feb-08	-13.3
Mortgage & Nonmortgage Loan Brokers	58.6	Jan-01	148.2	Apr-06	152.9	111.9	Dec-07	-24.5
Real Estate Credit	213.7	Jan-01	358.5	Oct-05	67.8	251.4	Dec-07	-29.9

Sources: Census Bureau, National Association of Realtors, Bureau of Labor Statistic.

Table 2
U.S. Economic Prospects

Economy (% Chg., Annualized, Unless Otherwise Indicated)	2007:4	2008:1	2008:2	2008:3	2008:4	2006	Annual 2007	2008	2009
Real GDP	0.6	0.2	-0.5	2.3	1.7	2.9	2.2	1.3	1.8
Consumption	2.3	0.5	-0.4	2.9	2.2	3.1	2.9	1.4	1.9
Residential Construction	-7.0	-7.6	-3.9	-2.9	-2.1	-4.6	-17.0	-19.9	-0.6
Business Fixed Investment	6.0	-0.6	-1.0	1.1	-1.0	6.6	4.7	2.6	-0.3
Inventories ($ Bils.)	-18.3	-16.4	-18.4	-23.0	-18.2	40.3	4.6	-19.0	-10.2
Real Net Exports ($ Bils.)	-503.2	-492.2	-485.2	-474.5	-473.1	-624.5	-555.6	-481.3	-473.7
Federal Government	0.5	1.4	1.4	1.8	1.7	2.2	1.7	2.3	1.7
State and Local Government	2.8	1.9	1.5	1.2	1.8	1.6	2.2	2.0	1.5
Inflation (%)									
CPI-U	5.0	4.5	4.3	3.6	2.9	3.2	2.9	4.1	3.2
Core Consumption Deflator	2.5	2.5	2.4	2.3	2.2	2.3	2.1	2.3	2.1
Wages	4.6	3.7	5.0	5.5	5.9	3.9	5.0	4.3	4.2
Employment and Unemployment									
Nonfarm Payroll (1000s, Chg.)	241	-232	-263	-175	-192	2,099	1,096	-1.357	-0.521
Household Survey (1000s, Chg.)	-49	-242	-307	-352	-150	3,171	262	-1.051	-0.875
Unemployment Rate (%)	4.8	5.0	5.2	5.4	5.6	4.6	4.6	5.3	5.8
Interest Rates (%)									
Federal Funds	4.31	3.06	1.92	1.79	1.79	4.96	4.93	2.14	3.00
3-Month Treas.	3.46	2.07	1.55	1.80	1.86	4.84	4.46	1.82	2.64
2-Yr. Treas.	3.47	2.01	1.75	1.86	2.00	4.81	4.35	1.91	3.16
10-Yr. Treas.	4.25	3.55	3.80	4.06	4.18	4.79	4.63	3.90	5.03
30-Yr. Mortgage	6.22	5.92	6.21	6.44	6.54	6.40	6.34	6.28	6.75
Adj. Mtg.	5.55	5.11	5.01	4.97	5.35	5.54	5.56	5.11	5.75
Housing and Housing Prices									
Housing Starts (Mils.)	1.151	1.059	0.982	1.007	1.054	1.812	1.343	1.025	1.209
New Home Sales (Mils.)	0.656	0.591	0.565	0.550	0.575	1.049	0.774	0.570	0.620
Existing Home Sales (Mils.)	4.387	4.186	4.037	3.991	4.075	5.703	4.958	4.072	4.250
New Home Prices (Med., 1000s)	236.5	234.9	214.7	198.5	191.6	243.1	243.6	209.9	201.5
Existing Home Prices (Med., 1000s)	205.7	195.6	191.2	185.4	176.1	221.9	215.5	187.1	180.4
Housing Determinants									
Affordability Index (higher means housing is less affordable)	0.141	0.133	0.131	0.125	0.116	0.153	0.146	0.127	0.120
Household Real Wealth (% Chg. Year Ago)	0.1	-3.5	-4.0	-4.6	-3.5	5.4	0.1	-3.9	0.0
University of Michigan Index of Cons. Sentiment	77.1	72.9	69.0	67.2	70.4	87.3	86.9	69.88	71.7
Real Disposable Income ($ Bils.)	8695.2	8724.8	9057.9	8847.1	8861.4	8396.9	8654.6	8872.8	9079.5
Federal Budget Deficit, Unified ($ Bils.)	-105.5	-213.8	27.1	-132.9	-163.9	-248.2	-162.8	-435.1	-505.4

Source: Decision Economics, Inc. (DE)

Economic, Mortgage and Housing Rescue Bill
Testimony to House Committee on Financial Services

Brian S. Wesbury
Chief Economist
First Trust Portfolios LP
April 9, 2008

I would like to thank Chairman Frank, Ranking Member Bachus, and the members of the Committee for this opportunity to discuss issues affecting the US economy. It is important to note that I am speaking for myself, and not for my employer, First Trust Portfolios LP.

I will summarize my written testimony, but respectfully ask that it be included in the record in its entirety.

As we all know, the economy and financial markets have been buffeted by turbulence. Defaults and delinquencies on mortgages (especially sub-prime loans) have risen rapidly, home prices have fallen, unemployment has risen, credit spreads have widened, and major U.S. financial institutions have taken large write-downs or have even been forced to sell themselves to avoid bankruptcy. Many prominent economists fear a recession.

Some even worry about another Great Depression, and Herbert Hoover has been discussed frequently. Unfortunately, many recent comments wrongly accuse President Hoover of sitting by idly while the economy collapsed. Nothing could be further from the truth. President Hoover was extremely active in the early 1930s, pushing unprecedented peacetime legislation and regulation, intervening in grain and labor markets, and using his bully pulpit to influence business decisions.

This is also true today – many unprecedented policy actions have taken place. The federal funds rate has been cut by 57% (5.25% to 2.25%), the most rapid seven month reduction in almost sixty years. Hundreds of billions of dollars have been injected into the US financial system, using new and innovative Fed facilities. Non-depository institutions now have access to the discount window and the Fed actively financed the purchase of Bear Stearns by JPMorgan Chase. Ten-years ago, a Fed-orchestrated meeting to assist Long-Term Capital Management was considered controversial.

A $150 billion stimulus bill has been passed, and the first rebate checks are scheduled to go out within weeks. Rules regarding Fannie Mae and Freddie Mac have been altered to allow more balance sheet leverage, and Federal Home Loan Banks (themselves a Depression-Era entity) have been authorized to buy more mortgage loans.

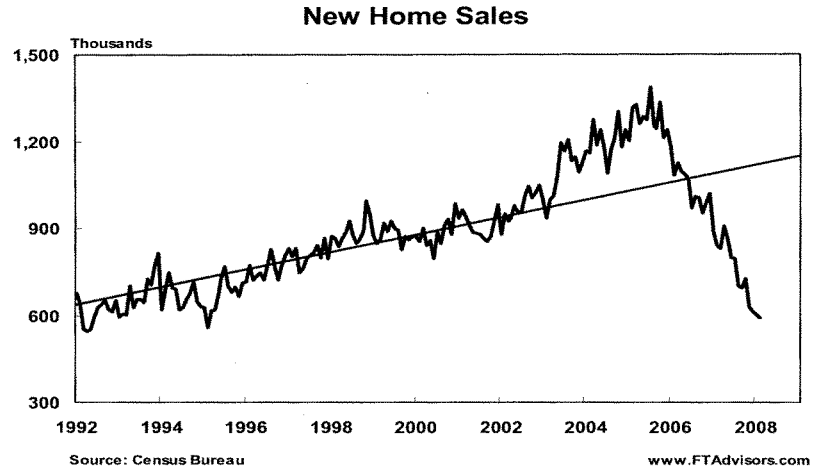
Now, Congress is proposing new legislation to help homeowners avoid foreclosure. Each of these actions, and every new proposal, is well intentioned. But, the road to serfdom is often paved with the best of intentions.

To discuss these issues today, I would like to ask and answer five important questions.

1) How did we get here?
2) Are today's problems unique?
3) Government Failure or Market Failure?
4) What Can the Government Do
5) Shouldn't we think twice before overreacting?

How Did We Get Here?

In hindsight, and as can be seen in the chart below, it is very clear that the housing market moved sharply above its long-term trend-line between 2003 and 2006. The question is: Why? Was it a shift in investor psychology? Was it just plain old greed?



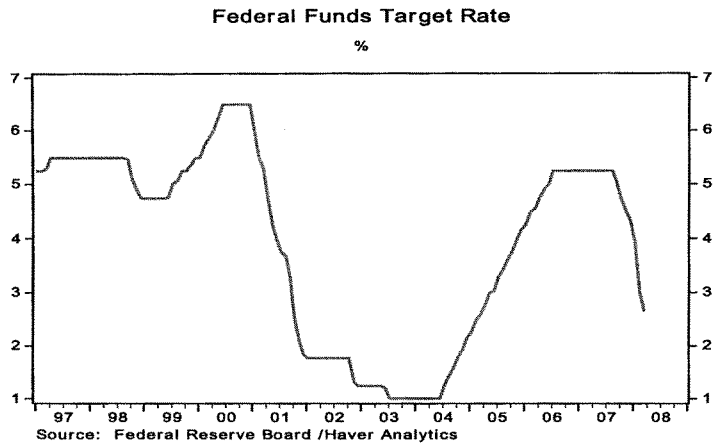
Some believe that the movement from fear to greed and back again is an almost random event. Or, as Herb Stein once said, "If something cannot go on forever, it will stop." Applying Stein's Law to housing says, "home prices will continue to rise and lending standards will continue to deteriorate until they don't anymore." At that point, whenever that is, the market faces a correction.

But this idea that consumers change from spendthrifts to misers overnight, or that investors shift from greed to fear randomly, is not supported by history. People don't change their nature; they change their behavior. They react. There are always "initiating causes" to any shift in consumer or business behavior. For example, people who live in Seattle own more umbrellas than people who live in Phoenix. This is not because people in Phoenix are spendthrifts, it's because it doesn't rain as much in the desert.

For the economy, the initiating causes of a change in behavior include the level of short-term interest rates, tax rates, regulations, and subsidies. All of these can influence incentives, and they therefore become driving forces behind a shift in economic activity.

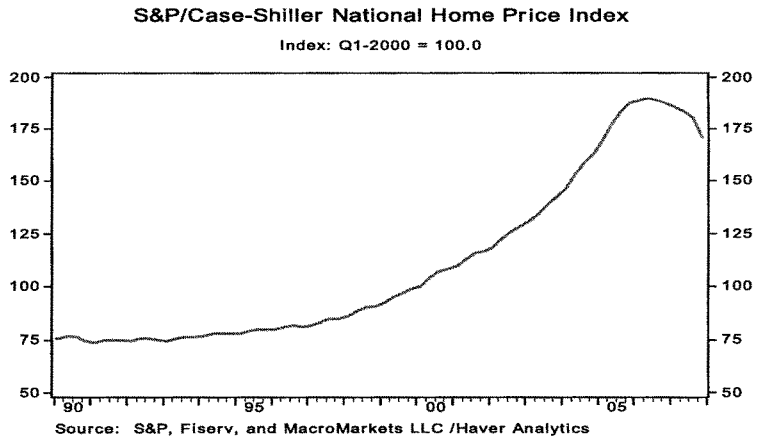
Ned Gramlich understood this. In a 2007 speech, the former Federal Reserve Board Governor outlined factors that led to rapid growth in subprime loans. One of those forces was the Community Reinvestment Act, which forced banks that operated in areas with low-income populations to make mortgages available to that community.

But the most important cause of the current mortgage market mess is excessively loose monetary policy between 2002 and 2005. The Federal Reserve cut the federal funds rate to 1.0%, held it there for too long, lifted rates too slowly and predictably and eventually stopped short of truly tightening monetary policy.



Interest rates were so low for so long that many people started to think they would stay low forever. Many adjustable-rate mortgage (ARM) borrowers thought they could refinance in one, two, or three years at the same low introductory rate they first agreed to pay. They took a calculated risk. Even Alan Greenspan, in February 2004, argued that ARMs were perhaps a better choice than fixed rate mortgages.

The extra demand for housing, driven by low interest rates and lax lending standards sharply lifted the price of homes. The S&P/Case-Shiller national home price index jumped by 60% between the fourth quarter of 2001 and the fourth quarter of 2005. Many regions of the country experienced much larger price appreciation than the national average and in these areas creative mortgage financing was used extensively.



The Case-Shiller national price index increased from roughly 80 in 1996 to 190 in 2007. Its recent decline to 171 has taken it back to early 2005 levels, but most homeowners have still experienced significant price appreciation.

Accommodative monetary policy was the grease in the wheels that allowed all this to take place with minor disruption to other sectors of the economy. Money was available to almost anyone, and it was cheap. Monetary policy was so loose and interest rates were so low, that housing became an investment that was too good to be true. Everyone wanted in, not realizing that much of these market movements were caused by an inflationary monetary policy.

Economists never know exactly what sector of the economy will be most affected by easy money, but in retrospect it is clear that in the 2000s, a great deal of the inflation ended up in the housing market, causing lenders and borrowers to drop their guard and take more risk than was prudent.

The Fed did not understand this at the time. If it had, it never would have left interest rates so low for so long. But in the early 2000s, gold, oil and other commodity prices rose sharply and the dollar fell abruptly. These market signals clearly indicated that Fed policy was too loose. But the Fed chose to ignore these signals at that time.

While some say that the Fed helped foment financial market problems with a lack of regulation, this is simply not true. There are few entities in the economy more regulated than commercial banks, yet the regulators were oblivious to the risk of excessive mortgage lending. The real problem was that regulators, banks and home buyers all believed that low interest rates and rising home prices were real, not a mirage.

When the Fed finally lifted rates back to "near normal" levels in 2006, the housing market lost its artificial support and fell sharply to levels well below the previous 15-year trend-line. In retrospect, this was inevitable.

Some argue that the US real estate boom could not have been caused by the Fed because real estate markets boomed in almost every major country around the world. But there are two flaws in this argument. First, the US is the only market that had such dramatic reductions in lending standards. Subprime loans are a unique American invention. Second, the demand for real estate in much of the developing world has been driven by the rapid spread of freedom and its commensurate increase in wealth (for example, in Ireland). The US benefited from this, but not to as great an extent.

Also, other countries have not experienced financial problems anywhere near the magnitude of the US. Most of this is because the US has run the easiest monetary policy of any developed country since 2002, but it is also true because of mark-to-market accounting rules.

Mark-to-market accounting rules are a fine idea in normal times, but when markets are illiquid, these rules can create serious problems. Banks and other financial institutions are being forced to write-down security prices to levels well below true fundamental value, creating phantom losses and reducing capital. This forces banks to raise capital, dilute current shareholders and reduce liquidity even further. When banks face capital problems they buy more Treasury bonds and make fewer loans. As a result, mark-to-market accounting rules are compounding economic problems.

Are These Problems Unique?

While it is safe to say there has never been a subprime mortgage crisis before, it is also safe to say that today's problems are not much different that those we have seen in the past. In fact, during the 1970s and 1980s, the oil and oil loan market went through the same set of problems that the housing market is going through today.

The Federal Reserve ran an extremely accommodative monetary policy in the 1970s. Inflation climbed from the low single digit level into double digits by the early 1980s, while oil prices surged from $3.56 to $39.50 per barrel (the equivalent of roughly $100/bbl. in 2008 dollars).

Many investors thought oil prices would never go down again and that "peak oil" was right around the corner. Lending expanded dramatically, with many banks feeling as if oil loans were not risky at all. They were wrong. When Paul Volcker tightened monetary policy and Ronald Reagan deregulated energy markets, oil prices fell by 25% to under $30 in late 1983, then to $25 per barrel in late 1984. Penn Square Bank in Oklahoma was a major oil lender and it was the first to go under in 1982.

While not as sophisticated as the securitized mortgage market, Penn Square sold participations in its oil loans to other banks. Continental Bank in Chicago (the eighth largest bank in the US) was one of those banks, as was Seafirst Bank in Seattle. All three of these banks failed. Insured Penn Square depositors were made whole, but non-insured depositors were not. Seafirst was bought by BankAmerica Corp., but Continental Bank was considered "too big to fail" and all its depositors were reimbursed after a direct federal bailout of the institution.

The economy moved through this crisis with minimal problems. The 1980s witnessed the second longest recovery in history up to that point. Interest rates, inflation and unemployment fell, and the stock market soared.

And all of this excellent economic performance continued despite the fact that the Savings & Loan industry became a victim of the 1970s inflation as well. When short-term rates and inflation shot up in the early 1980s, S&L's had to pay much higher rates to depositors than they could afford. After all, they still held many very low single-digit fixed rate mortgages from the 1960s and early 1970s. In other words, monetary policy mistakes in the 1970s helped cause losses of roughly $250 billion in the S&L industry.

Today's subprime loan problems, along with the Great Depression, the 1970s oil crisis, and the S&L crisis, can be blamed to a large extent on monetary policy mistakes. Understanding this is the first step to fixing the problems ahead. And one important lesson of history is that trying to fix monetary mistakes with fiscal policy compounds problems to a large extent.

Government Failure or Market Failure?

As should be obvious at this point, I have been making a case that government failure is more prevalent than market failure and that government failure is behind most of our current financial market problems.

Interestingly, many commentators have raised the specter of Herbert Hoover, and have suggested that the Great Depression was caused by his inactivity and inattention while the US economy fell apart in the 1930s.

But nothing could be further from the truth. One of the leading causes of the stock market crash and the decline in agricultural prices in the late 1920s and early 1930s was a harshly deflationary monetary policy. Rather than encourage the Fed to print more money, the Hoover administration signed the Smoot-Hawley Tariff Act into law in order to help fight off foreign competition and counteract falling farm prices.

President Hoover also used his bully pulpit to persuade businesses to keep wages high, despite deflation. After the market crashed in October 1929 he convened White House conferences on November 18, 21, 22, 27, and December 5. These meetings were designed to coordinate public and private sector actions to counteract the economic contraction. Hoover asked businesses to invest and keep wages high. He also accelerated government construction projects and increased public works projects.

The Treasury Department provided $100 million to make low interest loans to farm cooperatives, and in 1930 the government started to directly purchase wheat. In retrospect, it is clear that all this activity made the Depression worse than it would have been otherwise.

Protectionism caused global trade to collapse and pushed exporters and importers into bankruptcy. The Hoover tax hikes of 1932 reduced incentives to invest. Crop price supports encouraged excess production, causing even deeper price declines. Artificially high wage rates led to a more rapid increase in unemployment. The deflation caused by excessively tight monetary policy compounded all these problems and thousands of banks failed in the process.

If the Federal Reserve had started printing money immediately in 1929 and 1930, and government had not intervened to such an extent, the Great Depression could have been very mild and short-lived.

The Federal Reserve Board has learned from this history. Many believe it is the lessons of the Great Depression that have encouraged the Federal Reserve to cut interest rates so aggressively in recent months. The Fed's fears of a Depression have encouraged it to do everything humanly possible to stop any potential systemic problems in the global financial system.

What Can the Government Do?

Because financial markets move at lightning speed, but the real estate market moves glacially, losses have mounted more quickly at the investor level than at the homeowner level. And since there can be very few homeowners without lenders, the government's focus on stabilizing the banking system is appropriate.

The good news is that a combination of private (foreign and domestic) and public (Federal Reserve, Fannie Mae, Freddie Mac, and Federal Home Loan Bank) capital should be more than enough to absorb the losses in subprime mortgages.

Even if 50% of all subprime mortgages move into delinquency, and banks recover only 50% of the value of homes that are foreclosed on, the total losses should peak at somewhere near $300 billion. In a $14 trillion economy, with more than $100 trillion in assets, losses of this magnitude can be absorbed relatively easily.

While many analysts want to double or triple count these losses – adding the loss on the home, with the loss to the investor, with the loss to the bond insurer – this is not appropriate. Every loss beyond the actual loss on the property is a zero sum loss. There is a winner and a loser and the gains and losses net to zero. This is not true at the street level. The loss on a home is not offset by a gain.

Institutions and investment vehicles that do not have adequate capital face extreme problems and are being forced out of business. There are numerous examples of this. However, making these problems worse is "mark-to-market" accounting regulations which force many financial institutions to write down the value of assets to below fundamental value and reduce their capital by an equal amount. This puts them in jeopardy of violating financial accounting regulations and forces them to dilute current shareholders.

In turn, these pressures on the financial system reduce the availability of credit and drive up the cost of mortgages. Higher interest rates then drive down demand for housing and lengthen the market clearing process. The market must clear before anything can get back to normal. In other words, mark-to-market accounting rules are making it harder for the economy to recover.

While it is true that falling home prices have pushed many homeowners into a negative equity position and that these homeowners are the most likely to walk away from their mortgages, it is also true that many of them have risked very little capital. In the final year or so of the subprime lending frenzy, no-money down loans became common. In essence, the lending institution became a landlord. While it was called a mortgage, the purchaser had no skin in the game.

The idea was that home prices would continue to increase and homeowners would grow into an equity position. Unfortunately, this did not happen for many homeowners as housing prices peaked in 2006. These are the homeowners most at risk of defaulting on their mortgage. However, because many of these people never put any money down in the first place, it is hard to see the actual economic damage that would result from allowing a foreclosure to take place.

In fact, after a foreclosure takes place, and the price of the home is marked down, someone who has wanted to buy a house but was waiting for lower prices can now enter the market. If the government steps in and negotiates a lower mortgage balance for the person who is currently living in the house this process is short-circuited. It's picking winners and losers and it up-ends the market clearing process.

Trying to save institutions and individuals from financial pain caused by bad decisions is a noble cause. However, the unintended consequences that result from an overactive government are palpable. The best the government can do is to make certain that the economy remains resilient so that it can absorb the losses already in train and provide a positive backdrop for recovery.

Shouldn't We Be Thinking Twice and Acting Slowly?

Thinking through issues is important. For example, the Fed's sharp cuts in interest rates over the past seven months have probably prolonged the recovery process. While they may have seemed appropriate at the time, they have compounded problems.

For example, Fed rate cuts are the most likely cause of a spike in oil prices from $70 in August 2007 to a recent all-time high of $110 per barrel. The rising price of fuel helped push four airlines into bankruptcy in just the past few weeks. Rising fuel prices have also put more pressure on consumers and other businesses.

It is these inflationary pressures that will eventually cause interest rates to rise from current low levels. Higher interest rates and rising inflation will interfere with business and financial markets in the years to come.

While it is true that lower short-term interest rates are helping many homeowners who have adjustable rate mortgages, it is also true that as long as consumers and businesses expect the Fed to cut rates again they will hold off on investment decisions. Why make a decision today if the Fed will cut rates next week? This has definitely contributed to the slow economy of recent months. A more rapid set of rate cuts, with a statement that there would be no more to come, would have alleviated this problem.

Better still would have been for the Federal Reserve to follow the approach of the European Central Bank (ECB). The ECB has not cut interest rates at all, but immediately made available large sums of liquidity that allowed European financial institutions to ride through the storm so far, but without boosting inflationary pressures.

Because the Fed eased aggressively, while the ECB did not, the value of the dollar has plummeted. This has encouraged capital flight away from the dollar. A foreign holder of US mortgage bonds has higher losses than a domestic holder because the foreign holder has taken a currency loss as well.

In other words, government action has compounded problems faced by the US economy. And this is why Congress should not move to get the government involved more deeply in the housing market.

A widespread effort by the federal government to create more homeowners is one of the key causes of today's financial market problems. Risking billions of taxpayer dollars to stabilize a situation that was caused by monetary policy to begin with makes as much sense as the government's actions during the Great Depression.

With large Fed rate cuts already in place, hundreds of billions of dollars coming from the Fed and other government agencies, and rebate checks almost ready to mail, the economy is highly likely to avoid a recession. While many people will face pain from their decisions in the years ahead, the real fear is that government action turns a significant problem into a gigantic one. Let's avoid that road to serfdom.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

LAWRENCE B. LINDSEY
MEMBER OF THE BOARD

April 12, 1995

The Honorable Barney Frank
United States House of Representatives
2210 Rayburn House Office Building
Washington, DC 20515-2104

Dear Congressman Frank:

This letter responds to an issue you raised during the hearings held by the Subcommittee on Financial Institutions on March 8 regarding reform of the Community Reinvestment Act. You asked whether we knew of any circumstances in which loans to low- and moderate-income borrowers had caused safety and soundness problems for a bank or thrift, due to default, delinquency and the like.

I believe my quick answer at the time was "no." Certainly, the anecdotal information I have heard would indicate that loans to low- and moderate-income people perform with respect to repayment as well as, and in some cases better than, loan to others. Furthermore, I have heard of no cases in which a bank's portfolio contained such a large number of such loans that even if a significant number of the borrowers defaulted, it would put the bank in a seriously adverse safety and soundness position.

After you raised the question, I took some time to seek out some harder data and studies that might illuminate the matter. I was not able to find a lot in this vein, but I'll briefly share what I was able to locate. One reason for the few studies on the matter, I suspect, is that the data necessary to conduct them are, rightly I believe, generally closely and confidentially held in the loan files of the customers. Consequently, producing the necessary data, without compromising confidential information, can be time-consuming and expensive.

Nonetheless, the Woodstock Institute in Chicago conducted a study of the performance of residential loans in low- and moderate-income areas as compared to loans made in other neighborhoods. The October 1993 study based its conclusions on a sample of 2231 loans collected by the National Association of Affordable Housing Lenders from seven willing lenders. A few of the more interesting findings of this study regarding single family loans in low- and moderate-income areas were (1) over half of all loans that were ever delinquent were delinquent only once;

(2) the delinquency rate for loans that had been delinquent for 90 days or more was one tenth of a percent; and (3) the delinquency rates for a national sample of loans, containing data on loans in areas of all income levels, was 7.5 to 8.5 times greater. The same study reviewed the performance of multifamily loans in low- and moderate-income areas and, though the characteristics of the data sets did not allow the researchers to make perfect comparisons, the study did conclude that the loans made in low- and moderate-income areas experienced delinquency rates one to three times greater than national samples. Foreclosure rates, however, seem more aligned to national samples. As a result, the combined delinquency and foreclosure rates for multifamily housing loans in low- and moderate-income areas were slightly superior to those gleaned from national samples reflecting loans in all income areas.

GE Capital Mortgage Insurance Company also did a study of its own loans that were originated between 1987 and 1991. It concluded that borrowers with annual incomes of less than $40,000 were eight percent less likely than those with higher incomes to become delinquent on their loan payments and that the lowest income group (less than $20,000 annual income) had the best delinquency performance.

In addition, Richard G. Fritz, Vice President and Senior Economist at the Federal Home Loan Bank of Atlanta, presented a paper in January of 1994 which highlighted results from his study on the performance of the Atlanta Mortgage Consortium. The consortium was created in 1988 shortly after the Atlanta Journal/Constitution newspapers published a series called "The Color of Money" that was critical of the racial distribution of mortgage loans made by Atlanta lenders. The paper, "Consortium Residential Lending and Community Reinvestment: An Analysis of the Atlanta Mortgage Consortium", shows that for loans made during what Mr. Fritz calls Phase I of the program's existence (roughly its first year), the consortium experienced heavy long term delinquencies (11.9%). However, adjustments were made to the consortium's lending criteria during the next two years or so (Phase II) and the delinquency rate was significantly reduced to 6.7%. The consortium continued to effectively serve the low-income population of Atlanta after making the underwriting adjustments for Phase II.

In order to contribute an additional measure of comparison regarding the consortium's lending performance, I would like to provide some national data for the time periods that roughly correspond to the two phases of the study. During the Phase I period, the national delinquency rate was 4.78% for all mortgage loans and 6.65% for all FHA loans (possibly a more

apt comparison given FHA's relative emphasis on a similar market). National rates during Phase II were approximately 5% for all mortgage loans and 7.32% for FHA loans. Further, I am informed by other sources that during the first quarter of 1995, the AMC experienced a 9.99% delinquency rate while all FHA loans in the state of Georgia experienced a 10.01% delinquency rate.

I think that this experience shows that, although it is possible to go too far in reducing credit criteria, it is also possible, with a sensible set of adjustments to those criteria, to serve low-and moderate-income areas effectively. It also demonstrates that the consortium approach to lending in these areas can serve to spread the risk and make this type of lending possible without undue risk to any individual institution. I think it is important, however, to put this discussion in a fuller context, and to indicate that the answers to the question you raised are probably more complex than this response has so far indicated, particularly with respect to FHA-insured loans. In this regard, I would point out that a recent study, co-authored by Glenn Canner, an economist here at the Board, showed that FHA-insured loans in low-and moderate-income areas experienced nearly twice the default rates (as distinguished from a delinquency rate) of those made in upper income areas during the sample period.

Finally, I would simply cite some statistics offered by the National Association of Community Development Loan Funds, reflecting loans made by its 41 member funds. Through 1993, these funds had made $193.1 million in 3,960 loans for housing and businesses. The Association reports that its members had financed 43,369 housing units, 88% affordable to low-income tenants. Loan losses through 1993 were $1.69 million, or .87% of the total.

I believe this information responds to the question you raised. As you can see, the potential answers are complex and may turn on the programs and experiences chosen for review and the comparisons made. Furthermore, I would add that though these studies and data appear reliable, I have not personally reviewed their underpinnings and can only offer them for your consideration. Additionally, aside from the issue of repayment performance, there is the issue of profitability. We have no studies on the relative profitability of loans in low- and moderate-income areas compared to other areas. We do know, however, that in many cases these loans are subsidized (the AMC loans are an example) or involve credit counseling or other risk mitigating aspects that have an impact on their performance as a matter of relative profitability. Nonetheless, I have not heard of situations involving loans of this type putting any banks at

risk. And the success stories for these kind of lending are numerous. If you would like any other details on these studies and data, please contact me.

Sincerely,

Lawrence B. Lindsey

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April 9, 2008

The Honorable Barney Frank, Chairman
Committee on Financial Services
2252 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Frank:

The 1.3 million members of the National Association of REALTORS® thank you for holding hearings on "Using FHA for Housing Stabilization and Homeownership Retention". Today, the mortgage crisis continues to grow as increasing numbers of homeowners face foreclosure. In 1934, the Federal Housing Administration (FHA) was established to provide consumers with a new financing alternative during a similar lending crisis. For more than 70 years, FHA served our citizens and our economy well.

In recent years, however, the FHA program stagnated. Unable to respond to changing buyer needs, FHA failed to serve its core constituency and other mortgage providers stepped in to fill the gap. While some offered innovative and useful loan products, others offered problematic mortgages designed to take advantage of unsophisticated families eager for homes of their own. As a result, many homebuyers were lured into exotic mortgage products, ill-suited to their needs, and our current crisis was the result. Yet despite all of the current evidence of the need for safe, affordable FHA lending products - and the best efforts of you and others - FHA reform has yet to be achieved.

We urge you, your colleagues on the Committee and the Senate to continue to work towards enactment of FHA reforms. Permanent, realistic increases in the FHA loan limits, lowered FHA downpayment requirements, and new opportunities for condominium purchases are needed to create safe and affordable mortgage options for homebuyers and those wishing to refinance. These changes will also provide much needed stability to our local housing markets and economies.

We commend your efforts to develop innovative solutions with the "FHA Housing Stabilization & Homeownership Retention Act". Mortgage restructuring can help many homeowners keep their home with a loan they can afford. Your measure will allow homebuyers to refinance their mortgage with an FHA loan at a rate and level they can afford to repay. We are pleased to see underwriting guidelines to ensure that borrowers are likely to repay the mortgage and additional monies for counseling to make sure borrowers are able to retain their homes long-term.

Utilizing the FHA program as the vehicle for the refinanced mortgages makes sense, as it is an established entity with a proven track record. We believe it is critically important that these loans be separated from the Mutual Mortgage Insurance Fund and the General Insurance/Special Risk Insurance Funds to make certain the core programs that serve millions of homeowners and renters are not jeopardized.

The proposal also includes a program of loans and grants to states to help with local foreclosure problems. Foreclosed homes can quickly create blight in a neighborhood, and bring down the value of surrounding homes. The Woodstock Institute studied the impact of foreclosed homes on property values and found that, for every foreclosure within a city block, housing prices decrease between .9% - 1.1%. In lower

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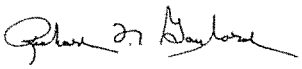
income neighborhoods, the decrease can be as much as 1.8%. Given a national median home price of approximately $200,000, a foreclosed home could reduce neighboring home values as much as $3,600 per foreclosed home.[1] Add another two or three foreclosures to a neighborhood and the implications for a neighborhood's home values are very significant.

The National Association of REALTORS® thanks you for your efforts to stem the housing crisis. Congress must act to help our nation's homeowners, communities, and local economies recover. REALTORS® stand ready to work with you on solutions.

Sincerely,



Richard F. Gaylord, CIPS, CRB, CRS, GRI
2008 President, National Association of REALTORS®

[1] "There Goes the Neighborhood: The Effect of Single-Family Mortgage Foreclosures on Property Values". Woodstock Institute, June 2005.

National
Urban League

Empowering Communities.
Changing Lives.

STATEMENT FOR THE RECORD OF

MARC H. MORIAL

PRESIDENT AND CEO
NATIONAL URBAN LEAGUE, INC.

Before the

HOUSE FINANCIAL SERVICES COMMITTEE

Hearing on

Using FHA for Housing Stabilization and Homeownership Retention

April 9, 2008

STATEMENT FOR THE RECORD OF

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On
Using FHA for Housing Stabilization and Homeownership Retention

April 9, 2008

Mr. Chairman, as President and CEO of the National Urban League (NUL), I offer this statement for the hearing record on the "FHA Housing Stabilization and Homeownership Retention Act," your new Economic, Mortgage and Housing Rescue proposal. At the outset, let me state that your proposal is the most specific statement to-date by a leading member of Congress calling for the use of federal funds to restore the housing sector's health. The proposal is substantive and speaks to the heart of the at-risk mortgage issue – these mortgages will either have to be partially forgiven by banks or refinanced by some entity.

Mr. Chairman, as you are fully aware, despite the successes of the FHA program, too many potential homeowners in underserved populations continue to be left out from the American dream of owning a home. FHA's market share has dwindled because its loan limits, inflexible downpayment requirement, and fee structure have not kept pace with the current mortgage marketplace. If FHA had been a viable mortgage alternative, many homebuyers would not have explored non-traditional mortgages, many of which are very risky.

Estimates may vary, but the number of home foreclosures is expected to continue to rise through at least the third quarter of 2008, probably into 2009. Our analysis of this crisis situation reveals that more than 1.5 million foreclosures could

occur this year, given certain economic conditions, as the nation experiences the 'second-wave' of so-called mortgage re-sets – adjustable and teaser rates that will be reset to higher rates to reflect the higher interest rate conditions produced by the credit crunch.

African Americans have the lowest homeownership rates in the nation – under 50%, compared to 76% for whites. Consequently, President Bush set a goal of creating new homeownership for over 5 million people of color by the end of this decade. We believe this is a worthy objective, but our broken subprime credit system must be repaired before homeownership can truly become the wealth-building vehicle it was intended to be. Without a healthy, fair and affordable mortgage market, the gains of homeownership for people of color will drain away through foreclosure and equity-stripping.

Mr. Chairman, your Economic, Mortgage and Housing Rescue proposal is extremely helpful and the National Urban League commends you for taking a lead on this issue. Your plan recognizes that much more help is needed for victims of the subprime crisis than is now available. We support the essential structure of your plan, which reflects a sound and fair way to provide help to distressed borrowers.

A strong point of the plan as proposed is that it would work alongside other needed plans. These include a measure now before Congress that would allow courts to modify mortgages so 600,000 families facing foreclosure could stay in their homes.

However, while we welcome any and all plans that help even one more family keep a home, it is unmistakably clear that the Treasury Department's "Project Lifeline" has been largely inadequate. Treasury's reliance on voluntary efforts by lenders to help distressed homeowners has simply proved unworkable on a large scale. Under your plan, in exchange for accepting a substantial write-down of principal, banks/lenders would receive payment from a new FHA loan that the borrower could reasonably pay.

The National Urban League is also pleased that the proposal also authorizes up to $10 billion in loans and grants to buy and rehabilitate vacant land, including foreclosed/abandoned homes. Helping states and cities acquire foreclosed properties and facilitate returning them to the tax rolls as owner-occupied or rental units is an innovative idea that will surely have a catalytic affect at the neighborhood level. We are particularly pleased that this provision will be targeted to those households with the greatest need.

It is the National Urban League's judgment that refusing to respond to the plight of families facing foreclosure not only lacks compassion, but is also bad economics. Everybody – homeowners, lenders, neighbors, indeed our entire economy – is worse off when a foreclosure occurs instead of a prudent write-down and appropriate refinancing. Our viewpoint is influenced by the outstanding work of more than fifty of our affiliates, whose certified counselors serve more than 40,000 homeowners per year by helping them understand the process and working with the client and their lender to develop a plan to resolve the delinquency and stabilize the homeowner.

Mr. Chairman, taken together – as proposed – these initiatives will help meet three crucial objectives. First, they will allow millions of families to avoid the disaster of losing their homes. Second, they will help hard-pressed local jurisdictions avoid the cascade of deteriorating neighborhoods and abandoned homes that follow in the wake of large-scale foreclosures. Finally, they will help stem the steep and destabilizing decline in home values that is intensifying the financial crisis.

Thank you for this opportunity to express our views and I look forward to working with you to see that that the "FHA Housing Stabilization and Homeownership Retention Act," becomes law. We have no time to waste!

National Urban League *(www.nul.org). Established in 1910, the National Urban League is the nation's oldest and largest civil rights organization devoted to empowering African Americans to thrive in the economic and social mainstream. Today, the National Urban League, headquartered in New York City, spearheads the non-partisan efforts of its 101 local affiliates in 36 states and the District of Columbia, providing direct services to more than 800,000 people annually, and impacting millions more through its advocacy and research.*

Response to questions from the Honorable J. Gresham Barrett
from Sheila C. Bair, Chairman,
Federal Deposit Insurance Corporation

Q1. What should be the goal of federal regulations? Should we just aim to ensure that fraud and malfeasance are punished? Or should the goal in regulations be stable growth?

A1. Federal banking regulations should not have a single focus. The central objectives of federal banking regulations are to maintain public confidence in the banking system; to support financial intermediation, credit availability, and competition; to enforce the public laws; and to protect consumers and encourage compliance with the Community Reinvestment Act. Capital requirements and other prudential regulations are tools used by bank regulators to promote safe and sound banking operations and to discourage excessive risk-taking. Banking regulations also attempt to minimize the risk of fraud.

Maintaining economic stability is a consideration in bank supervision, and the federal banking agencies recognize the importance of encouraging credit availability during periods of slower economic growth. While the Federal Reserve Board, in its domestic monetary role, is the federal entity primarily concerned with economic growth and stability, the other federal banking agencies also have a role by encouraging financial institutions to make credit available in the communities they serve on appropriate terms.

Q2. How much do you think our current mortgage crisis was caused by regulatory failures or lack of enforcement?

A2. As I mentioned in my testimony, the problems facing the U.S. markets are attributable to a complex set of interrelated causes. These include weakened lending standards, inadequate consumer protections, regulatory arbitrage, and speculative activity, as well as deficient surveillance by rating agencies and inadequate due diligence by originators and investors. The current turmoil in the credit markets also has been exacerbated by liquidity troubles that typically are not identifiable until funding problems emerge.

A significant volume of subprime mortgages were originated by companies (primarily mortgage brokers and stand-alone finance companies) not subject to federal supervision. In 2005, 52 percent of subprime mortgages were originated by companies not subject to federal supervision. An additional 25 percent were made by lenders affiliated with a regulated, deposit-taking bank or thrift, and 23 percent by regulated banks and thrifts. The FDIC estimates that the share of such loans made by nonbank entities not subject to federal supervision in 2006 was 46 percent.

For mortgage loans made by federally supervised depository institutions, the federal banking agencies issued a number of cautionary statements beginning in 1999 on a number of topics, including subprime lending, non-traditional mortgage lending, and commercial real estate loan concentrations. The purpose of these statements was to alert financial institutions to the risks involved and to encourage strong underwriting policies, prudent risk selection, and robust

concentration management procedures. Overall, the regulatory agencies strongly encouraged insured banks and thrifts to be cautious in their origination and management of subprime and non-traditional mortgage products.

From an enforcement standpoint, Congress has mandated routine on-site examinations for all insured institutions, which the federal bank regulatory agencies follow. Any institution that a regulator finds is performing poorly or has taken on excessive risk is typically directed to improve conditions or face enforcement action, including possible closure.

Q3. Are there any areas where onerous regulations led to evolution towards exotic products helping to cause the financial crisis?

A3. Financial innovation (including non-traditional mortgage lending and structured financial instruments/vehicles) and the abundant liquidity in global credit markets together fueled the development of non-traditional mortgages and financial structures. The development of these financial products was not precipitated by onerous regulation, but by financial innovation and abundant capital seeking higher returns. The highly liquid credit market environment from 2005 until mid-2007 led investors to seek higher returns by taking on increased credit risk and liberalizing repayment and loan terms.

Q4. If the government intervenes in the private market, do we have any additional regulatory duties to prevent this from happening in the future?

A4. I believe that we do have the duty to prevent a recurrence of the problems we now face. As I mentioned in my testimony, with regard to preventing practices in the future that contributed to the current issues in the mortgage markets, strong final rules by the Federal Reserve Board under the Home Owners Equity Protection Act (HOEPA) that impose basic principles of sound underwriting on both bank and non-bank mortgage originators are essential. An important complement to these substantive rule provisions would be the creation by Congress of a federal entity to buttress the efforts of the states to better license and police mortgage originators. The House of Representatives adopted a set of strong licensing provisions as part of H.R. 3915 last year. Similarly, the Treasury Department has proposed creating a Mortgage Origination Commission that, working with state authorities, would develop minimum national licensing qualifications for all mortgage market originators. Although these two approaches differ in some details, their best elements could be merged into a single proposal that would address this urgent issue and command widespread support.

I would emphasize that there is a particular urgency for Congress to act on legislation to establish national licensing standards for non-bank mortgage participants. As interest rates have declined, advertisements are once again promising low "teaser" rates, no-documentation and no-money-down loans, as well as using the term "fixed" in potentially misleading ways to describe the interest rate on variable-rate mortgage loans. Banks are not allowed to market, originate, or fund loans with such weak underwriting, but no such restrictions apply to non-bank mortgage participants nationally. Combined with strong final HOEPA rules from the Federal Reserve

Board, prompt passage of legislation creating a Commission to license and police mortgage originators would help prevent these practices from again misleading borrowers and adding more problems to the mortgage markets.

Questions submitted by Representative J. Gresham Barrett following the April 9, 2008, hearing entitled "Using FHA for Housing Stabilization and Homeownership Retention:"

1. *I believe strongly in the ability of the free market to correct itself and create economic growth and prosperity. However, I also know that the government does have a role in policing the markets. What should be the goal of federal regulations? Should we just aim to ensure that fraud and malfeasance are punished? Or should the goal in regulations be stable growth?*

The OCC operates under an array of federal laws and regulations and is responsible for continuously monitoring national banks to ensure their safety and soundness, the fair treatment of bank consumers, and bank compliance with appropriate legal authorities and policy guidance.

2. *How much do you think that our current mortgage crisis was caused by regulatory failures or lack of enforcement?*

The current mortgage crisis was not triggered by regulatory failures at federally regulated depository institutions or lack of federal enforcement, but rather, primarily by the lending practices of non-federally regulated lenders, which originated the majority of subprime mortgages. The vast majority of subprime loans, which have been the cornerstone of the mortgage crisis, were issued by entities not subject to federal oversight. These institutions are subject to uneven standards and enforcement at the state level. The absence of comprehensive standards applicable to all lenders and consistent, comparable supervision and enforcement of those standards were key causes of the current crisis. While subprime mortgages are a small percentage of all outstanding mortgages, their rising default rates have been felt throughout the financial sector.

Although national banks, which are subject to OCC regulation, originated less than 10 percent of the subprime mortgages originated in recent years, the OCC has repeatedly provided supervisory guidance to help assure that national banks' lending practices, including subprime mortgages, are sound and not abusive. Beginning in 2003, while the markets were robust and home prices were appreciating, the OCC started to address the more liberal underwriting practices that we detected in four consecutive annual surveys we conducted of credit underwriting practices. During this time, we were particularly troubled by looser underwriting practices in mortgage products. In 2004, because of our growing concerns with nontraditional mortgages, we specifically reviewed national bank originations of interest only and payment option ARM loans, including underwriting and marketing practices. By 2005, the OCC was directing its large bank examiners to discuss the inherent risks of offering new mortgage products with negative amortization features. In that year, the OCC led the interagency process to develop non-traditional mortgage guidance. That guidance was then followed by interagency guidance on subprime mortgages. The OCC has

continued to analyze and respond to changing mortgage conditions to assure sound and fair lending practices by national banks.

3. *Are there any areas where onerous regulations led to the evolution towards exotic products helping to cause the financial crisis?*

As mentioned above, the problems that contributed most significantly to today's financial challenges can be directly traced to the mortgage lending practices of non-federally regulated entities. By contrast, the mortgage lending conducted by national banks is subject to extensive federal regulations and oversight.

4. *If the government intervenes in the private market, do we have any additional regulatory duties to prevent this from happening in the future?*

Current conditions have highlighted the importance of appropriately identifying, measuring, managing and controlling risk. The OCC has various tools in place to influence the national banking system including: policy guidance and regulations that set standards for sound banking practices; on-site examinations and off-site monitoring that allow us to assess compliance with standards and identify emerging risks or trends; and a variety of supervisory and enforcement tools to obtain corrective action to remedy weaknesses, deficiencies or violations. These tools are dynamic and can be adapted and adjusted as necessary. For instance, in recent years, the OCC has issued more targeted, detailed guidance directly applicable to some of the specific portfolios that are of heightened concern including certain residential mortgage, home equity and credit card loans. Examiners are assessing banks' compliance with these guidelines as part of their routine examinations.

Governor Randall Kroszner subsequently submitted the following in response to written questions received from Congressman Gresham Barrett in connection with the April 9, 2008, hearing before the Committee on Financial Services:

We have heard a lot about trying to avoid a moral hazard, where the parties do not bear the full consequences of their actions. Still, it seems dangerous to allow financial markets to spiral out of control, possibly affecting the country as a whole, in order to teach certain parties a certain lesson.

- **How should we balance these two competing concerns--avoiding moral hazards versus keeping the economy stable?**

  The Federal Reserve has responsibility for promoting financial stability--the normal and efficient functioning of financial markets and institutions in a manner that appropriately reflects risks. As you suggest, in promoting financial stability, the Federal Reserve must take care--as must all other branches and agencies of government--to avoid promoting a view among private actors that they will be shielded from the consequences of willful bad actions. Were such a view to take hold among private actors, they could increase their exposure to risk, knowing that they would be spared the worst if their choices work out badly. To avoid moral hazard, government can and regularly does take crucial steps such as imposing regulation before the fact to limit the risk exposure that private actors are allowed to assume, and ensuring that those who benefit from the government intervention share in the cost of the situation overall, even if not to the same extent that they might have in the absence of the intervention.

- **Do you see any evidence that any of the parties that we are considering helping made their financial decisions anticipating government assistance?**

  In retrospect, of course, a large number of borrowers and lenders entered into mortgage contracts that have proven to be unsustainable. It appears that many of these contracts were entered into with the expectations that housing prices in the local area would continue to rise and that economic conditions would continue to be favorable, at least in the short- to medium-term. I am not aware of evidence that borrowers and lenders as a general matter entered into mortgage contracts in recent years with the belief that the government would intervene to cushion their loss in the event that their choices did not work out well.

- **Do you think that the FHA Housing Stabilization & Homeownership Retention proposal that we're discussing today allows the parties to feel enough financial pain to avoid creating a moral hazard?**

  Several provisions in H.R. 5830, as introduced, would impose costs on both the borrowers and lenders that participate in the bill's proposed FHA refinancing program. For example, the bill would require the lender to write down the principal amount of the relevant mortgage loan to 90 percent or less of the currently assessed market value of the

property. In addition, the bill would require that the lender pay an upfront premium equal to 3 percent of the principal amount of the FHA-insured refinancing loan and up to an additional 2 percent to cover associated origination fees or closing costs. The lender also would be required to waive all fees and penalties on the existing mortgage.

With respect to mechanisms for reducing moral hazard on the part of the borrower, there are several forms. First, most borrowers who will participate in the program are in a negative equity position on their home. This means that they have already lost the equity that they may have invested in their home when they took out their original mortgage(s) as well as any monies subsequently spent on improving their property. Second, the bill would require that the borrower, in exchange for being restored from a position of having negative equity in the home to a position of having positive equity, agree to pay the U.S. Government an exit premium equal to the greater of 3 percent of the original principal amount of the FHA-insured loan or a declining percentage of the proceeds received by the borrower on sale or refinancing of the home (net of the amount required to repay the FHA-insured loan). This means that transactions costs are fairly steep for the borrowers, particularly in an area with declining home prices, to sell their home to, for example, take a job in a different location. Third, the borrower is required to pay ongoing premiums to the FHA of up to 1.5 percent of the outstanding principal balance of the refinancing loan. That is, the homeowner who refinances using the program must compensate the FHA for the potential risks to the taxpayer. These mortgage insurance premiums increase the borrowing costs for these homeowners.

As I mentioned in my testimony, additional steps that could be taken to ensure that lenders and borrowers bear an appropriate level of costs would be to provide the FHA greater flexibility in setting the initial premium and annual premiums and to clarify the FHA's ability to charge risk-based premiums and use representations and warranties to manage risks.

- **If we do assist homeowners and lenders, are there any specific steps we can take to reduce moral hazard now or in the future?**

In the answer above, I have outlined some provisions that help defend against moral hazard. The potential for moral hazard on the part of borrowers also is substantially reduced when, as in the case of the introduced bill, participation by lenders or servicers is voluntary.

More generally, the Federal Reserve has taken steps to increase the likelihood that mortgage lending will be conducted on a sustainable basis in the future. For example, in rules that we have proposed under our HOEPA authority, we would require that borrowers qualify for higher-priced loans not using a temporarily low introductory interest rate but using a fully indexed interest rate.

In addition, I should underscore that most families who become seriously delinquent on their mortgage payments and potentially face foreclosure find the experience to be very stressful and costly. Even should the government choose to assist

homeowners in such circumstances, these facts likely will continue to act as a disincentive for homeowners to deliberately choose to go through that experience.

Our current situation is not the first time that the government has faced issues in the financial markets that required intervention. Unfortunately, this may not be the last time either.

- **What lessons should we take from past interventions that we should apply to this discussion?**
    - **What worked in the past and what did not work?**
    - **What aspects of past interventions may have had a part in causing this current crisis?**

One relevant lesson from a past experience that should be applied here is that it is important for financial institutions to recognize their losses in a timely manner and promptly rebuild their capital bases, so that they are once again positioned to extend credit on a sound basis. This was the basic approach taken during the early 1990s, when distressed assets were disposed of on a timely basis. By contrast, Japan took a different approach--a choice that is widely believed to have contributed to their experience of the so-called Lost Decade. The recent report from the President's Working Group on Financial Markets provides an extensive review of the recent period of financial turmoil, including a preliminary set of lessons learned and policy prescriptions.

- **Is there any way that we can avoid financial market meltdowns in the future?**
    - **If so, is there anything you would recommend that we make part of any plan that you think would help us avoid financial market meltdowns?**

Bouts of turmoil have been a part of the financial landscape since the beginning of recorded financial history, so constant vigilance is required. To minimize the chances of such turmoil, we must take care to ensure that market discipline is allowed to limit the risks assumed by financial actors; that government regulation provides a backstop to market discipline in cases when private incentives alone would not be enough; and that when the government chooses to intervene, it does so on a targeted and carefully designed basis. In my written statement, I offered several suggestions for steps that could be taken to limit the scope for moral hazard in the context of this bill. More generally, the recent report from the President's Working Group on Financial Markets provides a more comprehensive diagnosis of the origins of the current turmoil and prescriptions for strengthening our financial system. In addition, the Federal Reserve is studying these issues in light of the recent market turmoil and the actions the Federal Reserve has taken to improve liquidity for depository institutions and primary securities dealers. The Federal Reserve will share any recommendations it reaches with Congress as it completes its review.

Financial Services Committee Hearing
"Using FHA for Housing Stabilization and Homeownership Retention"
Wednesday, April 9, 2008

Question: I believe strongly in the ability of the free market to correct itself and create economic growth and prosperity. However, I also know that the government does have a role in policing the markets. What should be the goal of federal regulations? Should we just aim to ensure that fraud and malfeasance are punished? Or should the goal be stable growth?

Answer: Federal regulations can serve several goals. Among them are ensuring that fraud and malfeasance are punished, providing a level playing field to help competition flourish on a nationwide basis, and helping to ensure that long-term interests are considered in situations where the market may take a short-term view.

Question: How much do you think that our current mortgage crisis was caused by regulatory failures or lack of enforcement?

Answer: OTS does not believe that the current mortgage crisis was caused by regulatory failures or lack of enforcement. When an institution's lending programs are found to be potentially predatory or lacking adequate controls to support responsible lending, there are numerous options the OTS can take to stop these practices and correct the situation. These include formal enforcement actions and informal agreements. Our jurisdiction and oversight of an institution's lending programs also extends to the holding companies, affiliates, service providers, and other contractual relationships that an institution may utilize.

There are numerous examples of the actions taken by the OTS in the course of examinations of the institutions that we regulate. While we find informal actions to be an effective mechanism to address these types of supervisory concerns, we do not hesitate to use our formal enforcement authority when appropriate to do so. Fundamental to our continuing oversight of the industry we regulate is ensuring that institutions conduct their activities in a manner consistent with sound consumer protection.

Question: Are there any areas where onerous regulations led to evolution towards exotic products helping to cause the financial crisis?

Answer: Regulations and statutes should be periodically reevaluated to help avert situations where a statute or regulation crafted to avert or deal with one set of problems in one set of market conditions inadvertently contributes to the rise of another set of problems in different conditions. OTS does not have an example of an area where onerous regulations led to evolution towards exotic products helping to cause the financial crisis.

Question: If the government intervenes in the private market, do we have any additional regulatory duties to prevent this from happening in the future?

Answer: The government intervenes in the private market for many reasons. If the government intervenes in the private sector to address the consequences of a market failure, that is, if societal costs that the government is addressing arose because the private sector participants did not fully bear or enjoy the relevant costs and benefits of their actions, then the government has a responsibility to address the market failure that created the situation. For example, OTS has suggested that development of a national registry of mortgage brokers to replace the current fragmented system of oversight would encourage more responsible business practice and facilitate accountability.

MAY 19 2008

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

May 16, 2008

The Honorable Paul E. Kanjorski
United States House of Representatives
2188 Rayburn House Office Building
Washington, DC 20515-3811

Dear Representative Kanjorski:

This letter replies to your request, during the April 9, 2008 hearing before the Committee on Financial Services, for our views on S. 2860, the Fair Value and Independent Appraisal Act, as introduced by Senators Casey and Martinez. The OCC strongly endorses the principle that real estate appraisals must be conducted free from influence or coercion by any participant in the mortgage lending process, and we support the application of strong, uniform appraisal standards, rigorously enforced by the appropriate Federal and State regulators. With particular respect to S. 2860, we would make the following comments.

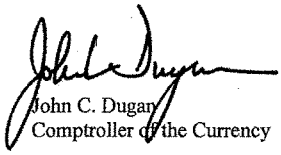
First, this bill amends the Truth in Lending Act to prohibit unfair or deceptive acts or practices in providing mortgage lending or brokerage services, and it vests rulemaking authority to define these acts or practices in the Board of Governors of the Federal Reserve System and the Federal Trade Commission (FTC). Because these regulations also would apply to banks and thrifts regulated by the OCC, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, we believe rulemaking authority should be provided jointly to the four Federal banking agencies and the FTC. This approach, which will promote uniformity and consistency in standards that apply nationwide, is the approach taken in the appraisal provisions that you authored and that have been included in H.R. 3915 as passed by the House. Moreover, H.R. 3526, as passed by the House last December, provides for joint rulemaking authority with respect to unfair or deceptive acts or practices under section 5 of the Federal Trade Commission Act, a result that the OCC, together with the other Federal banking agencies, has supported.

Second, S. 2860 prohibits as an unfair or deceptive act or practice the failure to "timely compensate an appraiser for a completed appraisal, regardless of whether the transaction closes." The other three activities that this bill prohibits as unfair and deceptive practices per se all relate to the independence of the appraiser and the integrity of the appraisal process and directly affect the borrower and the underlying mortgage transaction. In contrast, this activity relates to the timing of compensation arrangements between an appraiser and the lender and there could be various reasons, such as the quality of the appraisal, that could be relevant to the compensation paid. In our view, this is a matter that is most appropriately considered in the context of rulemaking, where the issue can be evaluated in light of current industry practices and concerns,

if any, that such practices have raised. We would therefore recommend that it be removed from the statutory list of per se unfair and deceptive practices.

Thank you for the opportunity to provide the OCC's views on S. 2860. We look forward to working with you as the Congress continues to consider these important issues.

Sincerely,



John C. Dugan
Comptroller of the Currency

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REVIEW & OUTLOOK

Uncle Subprime

April 3, 2008; Page A14

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Mortgage foreclosures haven't yet hit their peak, it's an election year, and Congress is back in session. Hold onto your wallets because a housing bailout is moving forward unless the White House says no.

Senators from both parties agreed late yesterday to throw about $11 billion more at the housing market, and we'll have more to say about that later. But think of Uncle Sam as the subprime lender of last resort and you are getting close to what the Beltway is contemplating. In the name of preventing foreclosures, House Financial Services Chairman Barney Frank wants to transfer the risk of further declines in home prices to taxpayers from lenders and borrowers.

Barney Frank

Mr. Frank's idea is that, for mortgages originated between the start of 2005 and mid-2007, a lender and borrower would be able to agree on a federal refinancing plan. Lenders would have to write down their loan to no more than 85% of the current appraised value of the property – which means the banks will use this opportunity to unload the biggest stinkers in their loan portfolios.

For the borrower, the deal is even sweeter: a low fixed monthly payment and a reduction in the principal to market value. The Federal Housing Administration would then guarantee the loan, up to a total of $300 billion in total Frank Refis. The deal is so sweet that even Mr. Frank is concerned that otherwise reliable borrowers may "purposely default" to be eligible for assistance. His solution is to require borrowers to "certify" that they really, truly aren't doing this simply to get on the taxpayer gravy train.

The pols also understand, but won't admit, that you can't bail out borrowers without bailing out lenders. And on both counts, we're not talking about the most deserving recipients in the history of welfare: Those receiving bailouts will be lenders who chased high returns despite the risks, and borrowers challenging historic rates of delinquency even before rate resets. Many will also be fraudsters, given that mortgage fraud has increased more than 1,200% since 2000.

A new study from the Boston Federal Reserve destroys the myth of the victimized subprime borrower. Boston Fed economists examined 1.5 million homeownerships over nearly 20 years and found that the overwhelming reason for subprime foreclosures is not unsustainable debt foisted on ignorant borrowers or even financial setbacks. People walk out on subprime mortgages when the value of their home declines.

Homeowners who've suffered a 20% decline in home prices are 14 times as likely to default as those who have enjoyed a 20% gain. "Subprime lending played a role but that role was in creating a class of homeowners who were particularly sensitive to declining house price appreciation, rather than, as is commonly believed, by placing people in inherently problematic mortgages," says the Boston Fed study. In other words, even if the government moves these borrowers into FHA-guaranteed mortgages with fixed rates, but home prices keep falling, lots of borrowers will stiff the taxpayers like they've been stiffing private lenders.

Traditionally, lenders making a commitment to finance your home have demanded that you make a commitment as well: a down payment. But during the credit boom, the shrinking market share of FHA-insured loans demonstrated how much the world was changing. FHA was intended to help moderate-income borrowers afford homes by requiring merely a 3% down payment. When subprime lenders started offering loans with zero down, FHA asked Congress to let their lenders do the same. Fortunately for taxpayers, Congress resisted. In the fourth quarter of 2007, FHA loans were one mortgage category that actually enjoyed a decline in foreclosures.

That trend may not last, because Mr. Frank's bill waters down FHA underwriting standards. Today, the FHA tells lenders that a borrower should not have debt payments amounting to more than 43% of monthly income, but Mr. Frank's bill allows this figure to rise as high as 55%.

Under current FHA guidelines, lenders must also closely examine a borrower's credit history. Yet under the "flexible underwriting standards" in Mr. Frank's draft, borrowers can't be denied FHA insurance due to a low credit score. Delinquency on existing mortgages also can't be the sole reason to deny FHA insurance. Mr. Frank's bill authorizes the Secretary of Housing and Urban Development to contract out for a new underwriting system, and it should be entertaining to see what HUD's political minds can devise to appease pressure groups.

In sum, Mr. Frank is volunteering U.S. taxpayers to insure $300 billion in mortgages with underwriting standards to be named later. Connecticut Senator Chris Dodd thinks $400 billion is more like it. Quavering Republicans should do the political math. The Mortgage Bankers Association tracks 46 million mortgage borrowers, and 42 million are paying on time. More than 20 million households own their homes outright and, having worked for years to pay for them, probably don't want to pay for someone else's. Neither do 35 million renters who didn't take a flyer on nicer digs.

The good news is that a taxpayer champion is emerging from, of all places, Florida. His state is ground zero in the housing downturn, but House Republican Tom Feeney says, "My constituents are not terribly sympathetic with borrowers who made bad decisions." We're told the White House will oppose the Frank-Dodd bailout, but if there's any doubt, Mr. Bush should have Mr. Feeney in for a chat.

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