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TURMOIL IN U.S. CREDIT MARKETS: EXAMINING PROPOSALS TO MITIGATE FORECLOSURES AND RESTORE LIQUIDITY TO THE MORTGAGE MARKETS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

THE HOPE FOR HOMEOWNERS ACT AND OTHER PROPOSALS TO ADDRESS THE ONGOING TURMOIL IN THE CREDIT AND MORTGAGE MARKETS WITH FOCUS ON THE IMPLEMENTATION OF VARIOUS PROPOSALS TO ADDRESS THE FORECLOSURE CRISIS

WEDNESDAY, APRIL 16, 2008

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TURMOIL IN U.S. CREDIT MARKETS: EXAMINING PROPOSALS TO MITIGATE FORECLOSURES AND RESTORE LIQUIDITY TO THE MORTGAGE MARKETS

WEDNESDAY, APRIL 16, 2008

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:05 a.m., in room SD–538, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Let me thank our witnesses this morning and those who have gathered in the Committee room to be here for our hearing this morning entitled "Turmoil in the U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets." And, again, I want to thank everyone for their participation over the last several weeks. We have had a very busy Committee activity, and it will continue as such. We have an awful lot on our plate, obviously, and so yesterday's hearing was, I thought, a very good one, and I appreciate immensely the participation of as many Members.

I know everyone has conflicting schedules as well, with other Committee assignments and responsibilities, but the fact that we have had as much participation by the Committee as we have had I think is an indication of how seriously every Member of this Committee takes these issues that we have in front of us. And I am particularly grateful to Senator Shelby and his staff, as well as my own, obviously, for the tremendous work being done and the effort made a week or so ago as we spent a good deal of time on the floor of the Senate grappling with at least our first efforts on trying to deal with the foreclosure issues. And while it was not everything that Senator Shelby wanted or I wanted or even things that are in there that we would not have necessarily written on our own, I think it was a major step in the right direction, and I am grateful to every Member of this Committee for their support in that effort.

This morning, we will continue that discussion, obviously, as we examine further the questions of how can we mitigate foreclosures, how can we really help unleash the pent-up capital that is out there. I mentioned to Senator Shelby that yesterday morning I had the privilege of meeting with a large group of people involved in commercial mortgage-backed securities and heard an earful about

their problems. Last year, I think that business did some $230 billion worth of business in 2007. As of the middle of April, they have done $5 billion worth of business this year. It is just frozen up entirely.

We heard that about 15 percent of lenders are no longer involved in the business of student loans, and those numbers could continue to skyrocket over the next several weeks and months. So any debate about whether or not there is a contagious effect in this issue I think has been obviously debunked by anyone who is listening to anybody else in various other sectors of our economy and how this is affecting us.

So whether or not we can do something to play a worthwhile and responsible role in trying to bring this to a halt and move in a different direction is the critical question before us—the liquidity, transparency, and, most of all, confidence in our markets.

So this morning, the Senate Banking Committee is meeting to hold its second hearing on the Hope for Homeownership Act and other plans to address the historic levels of foreclosures the American people are experiencing. This is Wednesday of this week. By the end of business today, another 24,000 people in this country will have filed for foreclosure, and roughly 1,000 a day will be in foreclosure. And every day that we move forward without addressing that underlying question, those problems will continue to grow.

There is a growing consensus that the Federal Government needs to get more aggressively involved in helping American families keep their homes. In addition to my legislation, the Office of Thrift Supervision has put forward a plan. HUD has proposed a plan. Senator McCain ha a plan. And these plans embrace the key concepts, I would point out, in the legislation that I have circulated, that Barney Frank and the House side has also been working on and holding hearings on, including use of the existing FHA platform to refinance distressed homeowners into new loans.

It is my hope that we can work collectively to bring together the best features of these various ideas and move legislation quickly before we watch any more people have to suffer the loss of losing the most important investment they are ever going to have in their lives. Our failure to act earlier has made the problems we now face more severe.

Mark Zandi, a well-known housing economist, put it this way, and let me quote him. He said, "Policymakers' initial response to last summer's subprime financial shock was very tentative as they misjudged its severity and the extent of its economic fallout. Financial markets and the economy subsequently eroded. Only if more homeowners are able to retain or remain in their homes will the negative cycle of foreclosures begetting house price declines begetting more foreclosures be short-circuited. This in turn is necessary to ending the down draft in the housing market that is weighing so heavily on the economy and the financial system."

Briefly, the legislation that I have proposed creates a new fund at the FHA to insure new affordable mortgages for distressed homeowners. These FHA mortgages would refinance the old troubled loans at significant discount. The new loans would be no larger than the borrowers could afford to pay and no more than 90 percent of the current value of the home. This formula is very similar

to the one laid out by Federal Reserve Chairman Bernanke in his speech several weeks ago when he noted that creating new equity for underwater borrowers may be a more effective way to prevent foreclosures. The administration has also embraced the concept. Under my proposal, no one—I repeat, no one—gets what would be described as a bailout. Lenders and investors will have to take a serious haircut to participate in the program. But, in return, they will receive more than they would recover through foreclosure. Borrowers get to keep their homes, but they must pay for the FHA insurance and share the newly created equity and future appreciation with the FHA program to help offset any possible losses. Only owner-occupiers would be eligible for this new program, and only those who clearly cannot afford their current mortgages.

There will be no speculators or investors allowed in this program. Not only would this initiative help deserving homeowners and the communities in which they live, this program would help stabilize capital markets, put a floor on excessive downward spiral of housing prices, and get capital flowing once again, which is absolutely critical, in my view.

In addition to the witnesses we heard from last week's hearing, the staff has been consulting widely with investors, lenders, servicers, economists, securitizers, regulators, and other Senate offices to improve the draft legislation. And we continue to seek input in order to make this product as strong as possible and move it forward as soon as possible. It is increasingly difficult to explain to the American people why it is that their government can act so quickly to put taxpayer dollars at risk to bail out, if you will, large financial institutions on Wall Street without making a more robust effort to help Americans keep their homes. In my own view, these efforts must go hand in hand. Before financial institutions can really get back on a steady course, we need to address the subprime and nontraditional mortgages underlying the alphabet soup of complex securities. While not a silver bullet, the Hope for Homeownership Act would, I think, help to do so.

The need for action continues to be acute. Yesterday, RealtyTrac released new data which showed that foreclosures filings jumped 57 percent in March from a year ago. This marks the 27th consecutive month of year-over-year increases in national foreclosure filings. And as I said a moment ago, another 8,000 families today in America will file for foreclosure; 8,000, roughly, did yesterday, the day before, and will tomorrow. At some point we have to step up and decide we are going to try and do something about that, and allowing it just to hemorrhage day after day after day is not an answer. Inaction is not an answer. And failure is not an answer.

So today we are gathering once again to try and think about ways in which we can make a difference. In America, in our America, this should not be acceptable. If we do not take effective action, we risk being forced to take more dramatic and costlier action to respond to more dire consequences down the road. That is what happened with Bear Stearns, obviously.

As I said last week, I understand that some people oppose this kind of program on the ground that we should not reward people who, in their view, acted irresponsibly. Let me respond by quoting Scott Stern, who testified last week on this very subject matter. To

remind my colleagues, Mr. Stern is the CEO of Lenders One, a coalition of 110 small and medium-sized mortgage lenders. Mr. Stern explained that he feels that the "condemnation of borrowers that took out risky loans is misplaced because of the growing practice of pushing high-risk loans on borrowers who had no reasonable expectation of being able to repay the mortgage." Mr. Stern called this "mortgage malpractice." He went on to say, "In our industry, we have frankly seen too much mortgage malpractice. Curing a loan that had a high risk of failure creates no moral hazard. Just the opposite. Modifying a loan which probably should not have been made in the first place is the kind of action that can help restore integrity and trust in the mortgage market."

Of course, some borrowers who might benefit from this program might not be deserving, according to some. But if we do nothing, we know for certain that hundreds of thousands of homeowners who need and deserve our help will lose their homes. That is why I believe we should act, and I look forward to working with my colleagues to craft the best possible solution to this problem.

And, again, I want to thank Senator Shelby immensely for supporting the idea of these hearings for us to listen to people who can offer some sound advice and counsel on how we move forward, and with that, let me turn to the Ranking Member.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

As we continue our examination of the mortgage market and various proposals for further Government intervention, I believe we must ensure that our actions do not reward, and thereby facilitate, imprudent financial decisionmaking. As this Committee heard in testimony last week, many areas of this country are likely to experience further price declines. In States such as California, a mortgage writedown of 10 or even 20 percent could likely still leave borrowers with negative equity in just a year or two. Encouraging a family with no real equity to remain in a depreciating asset may not make sense.

Mr. Chairman, I believe there is widespread agreement that many families, particularly those receiving subprime loans, were not quite ready for homeownership. If these same families were not ready for homeownership in a booming market, it is not clear to me how they become ready in a declining market. This, of course, begs the question. Who should qualify for taxpayer-backed assistance?

We continue to hear that over 2 million homeowners may be facing foreclosure. The pressure to act in the face of such a dire prediction can be overwhelming. But before we act, Mr. Chairman, I believe there needs to be a frank discussion about equity and moral hazard. If the Government is going to step in and prevent foreclosures, who will qualify for this taxpayer-backed borrowing? Are all these borrowers deserving? If not, which ones are and why? What do we know about the households facing foreclosure? What information is relevant and what is not? The answers to these questions should drive our policy choices because we will undoubtedly be rewarding some while penalizing others.

Mr. Chairman, I believe there is a consensus that we should not be bailing out investors or speculators, but there are other impor-

tant questions that need answers here. How many of these households made minimal or no downpayments on the properties they hold? How many of these households did a cash-out refinance on the same property and now face difficulty paying the higher mortgage cost? How many of these households have poor credit scores and have significant credit card debt? How many of these households face foreclosure because of an income decrease due to a voluntary job loss? Yes, how many homebuyers used exotic mortgage products, gambling on the ability to refinance in future years?

What do we tell the family that waited and made prudent financial decisions when we bail out the people who overreached? When did we decide that the overextended homebuyer is more deserving than the potential homebuyer who can now take advantage of declining home prices? What is the FHA's current financial condition? What impact would another significant expansion of the FHA have on the mutual mortgage insurance fund?

Mr. Chairman, I hope we can get answers to some of these questions at today's hearing. If we do not, I would encourage the Committee to continue exploring thoroughly all facets of your proposal before we act. I would also urge the Committee to expand significantly its examination of the in-time mortgage cycle.

Mr. Chairman, we are facing one of the most significant economic events in decades, and I believe we have a responsibility to understand how we got there, who is at fault, and whether we can prevent it from ever happening again. I believe the Committee needs to examine comprehensively the reasons behind the ongoing liquidity crisis and the downturn in the housing market. The examination, Mr. Chairman, I believe should start with the origination of home loans and proceed through the securitization process that you referenced to the ultimate holders of such loans. It should examine the role played by all market participants, including commercial banks, investment banks, credit rating agencies, mortgage brokers, realtors, home builders, finance companies, and Federal and State regulators.

I believe we should also examine the secondary effects of the downturn in the housing market, including the impact on the municipal credit markets, the availability of credit, and the condition of our financial institutions. The examination here should aim to provide, to the extent possible, an empirical basis for any conclusions reached so that any actions the Committee decides to take in the future are grounded in fact and not anecdotal evidence.

Among the topics that should be examined, I believe, Mr. Chairman, are: Who were the largest underwriters of structured finance products? Did investment banks conduct proper due diligence when structuring asset-backed securities? Were underwriters aware of the poor quality of many of the loans they were securitizing? And if so, did they properly disclose the risk to investors? Was the Securities and Exchange Commission properly overseeing the activities of investment banks and ensuring that the disclosures of structured finance products were accurate?

Were bank regulators properly monitoring the structured finance and derivatives activities of financial institutions? What role did bank capital requirements play in encouraging banks to move assets off their balance sheets through the use of securitization? And

will the new Basel II capital requirements eliminate or reduce the incentives banks have for securitizing assets merely to avoid capital requirements?

What benefit did structured finance products provide? Did out-of-date accounting standards lead to structured finance products being reported in an inaccurate or misleading manner on financial statements? Have accounting standards kept pace with innovations in financial products to ensure that the value of the new products is accurately reflected on balance sheets?

Further questions: How often was securitization used for regulatory arbitrage purposes, such as avoiding capital requirements, reducing taxes, or securing beneficial accounting treatment? And who were the largest investors in structured finance products? Were they conducting proper due diligence on the products they were buying? And is there any evidence of widespread misleading or fraudulent sales practices of structured products to investors? And why have the credit rating agencies downgraded so many structured finance products? And to what extent did foreign investment or the Federal Reserve's monetary policy fuel the sharp increase in housing prices? Did our current regulatory structure fail? If so, did it fail because it was not restrictive enough? Or did it fail because it was too restrictive, providing a false sense of security to market participants? And how significant was the role of real estate speculators in the run-up of housing prices? And to what extent did the practice of mortgage brokers, realtors, and home builders fuel the frenzy? And how often did buyers simply reach beyond their means when they purchased a home?

Mr. Chairman, after a thorough examination of the full spectrum that I have gone through of the collapsing mortgage market, the Committee, I believe, should examine potential reforms to restore confidence in and improve the operation of our financial markets. Mr. Chairman, as you do, I believe the responsibility of understanding what happened rests solely with this Committee. We are uniquely positioned on this Committee to inform the American people, and it is incumbent upon us to do so.

Thank you.

Chairman DODD. I thank you very much. Certainly we have been doing that, and we are going to act as well, I hope.

Let me ask if any other members here would like to be heard before we start. All your opening statements will be included in the record, but does anyone want to be heard? Tom. Jack.

STATEMENT OF SENATOR JACK REED

Senator REED. Just briefly, Mr. Chairman. Again, I want to commend you and Senator Shelby for holding the hearing and for your comments.

The fundamental assumption that most people on Wall Street had and most people around the kitchen tables of America had was that housing prices would not go down, and for the last decade or more, they had been formulating their economic strategies based on that assumption. And that assumption is not valid, and as long as they feel that there is no floor on housing prices, I think both decisionmakers on Wall Street and Americans across the country will not get their financial traction, will not start spending again, will

not start feeling comfortable about the future. And we have to act, I think, promptly to restore a floor.

There are various proposals. I think we can do an analysis, we must do an analysis, but we have to act. And, to date, the voluntary efforts of the administration have been modest at best in terms of reaching people who are in danger of foreclosure, and also reaching people who are paying their mortgages but they are underwater. Their mortgage is much greater than the value of their home. And that means they are not going to go out and take money out to send children to college; they are not going to go out and take money out to buy something. And, again, this is all adding to a recession that is upon us.

So I think we have to act, and I hope this hearing will give us insights for prompt and timely action. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

I would remind the Committee we are going to have Chairman Cox here next week to be talking about the role of the SEC and the credit agencies. We have had a series of hearings, and we will continue. Obviously, as Senator Shelby points out very accurately here, we have an obligation to know how this all happened, and certainly that is an important role and an ongoing one.

I would also suggest we have a commensurate responsibility, of course, to act to make sure this problem does not grow worse. And my concern is it is. We had Larry Summers the other day talking about—I think, Jack, to pick up on your point—some 15 million homes now are underwater; that is, debt exceeds equity, and those numbers are growing. And, obviously, you go back to what values were before, Bob Corker likes to point out, and rightly so, that, you know, we are looking at values today versus where they were a few years ago in terms of reality and all of that. In the meantime, obviously, a lot of wealth is being lost.

So we have two roles: one, to find out what happened; and, two, to make sure we take steps to see to it that we short-circuit this problem before it gets completely out of hand.

Wayne, do you want to——

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I would like to just say that both you and Senator Shelby are bringing up some very credible questions that we need to continue to work on finding the answers on.

I do have some reservations on taking FHA, which has a troubled past, and adding more risk to a newly recovering agency which would put taxpayers on the hook. So I hope we can be cautious about that.

Chairman DODD. Thanks very much for that.

Anyone else want to be heard? Tom.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. I am happy today to welcome our witnesses, and I look forward to your testimony. Some of you have already given us plenty of food for thought.

I would just remind my colleagues as we approach this hearing, we had the opportunity during the debate on the Housing Recovery

Act, which we passed by a wide margin a week or so ago, and I applaud the Chairman and Ranking Member and others who helped to make that happen.

You will recall that we had an opportunity to consider a proposal by Senator Durbin to empower a bankruptcy judge to modify the amount of principal that is owed in a primary mortgage, and we decided, by a fairly wide margin, that we are not going to do that. That was one effort to try to address the problem here that the Chairman would have us consider, and that is, where people owe more money on their home than their home is worth, and the value of the home might still be dropping.

I am not interested in rewarding bad behavior. I am not interested in rewarding bad behavior on the part of borrowers or lenders or investors. I do not think any of us are interested in doing that. But I know that if Bob Menendez and I were neighbors and my home goes into foreclosure, there is a problem certainly for my family, but there is also a problem for him and his family and other people who live in my neighborhood because the value of their homes are going to go down as my home in foreclosure decays and is deteriorated.

There are a number of good, constructive ideas of how to move forward on this. I think the Chairman's proposal is certainly that. I think Congressman Frank has that. OTS has suggested a good idea. FHASecure is a good idea. Somewhere in the mix of all that is, I think, very good public policy that will help address the problem, the dilemma that is faced not just by the folks that are going into foreclosure, but also by the people who live in those neighborhoods, and to do it in a way that does not put taxpayers needlessly at risk.

There is a way to do this, and I am very hopeful that we will find that way.

Chairman DODD. I hope so as well.

Anyone else want to be heard on this? Bob.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman. I only wish I could live next to Senator Carper. I just cannot afford it.

[Laughter.]

Senator CARPER. We would have to change the Constitution. There would be three Senators from Delaware.

Senator MENENDEZ. It would be a pleasure to live next door to him. But I just want to say I appreciate you continuing this series of hearings. You know, I have to be honest with you, Mr. Chairman. The terms of the administration's proposals, both past and present, I am somewhat at a loss for words. I do not know what else Members of the Committee can say or the economists can say or the consumers can say that presents and convinces the administration the size of the crisis that we are facing. And I think a serious crisis deserves a serious and significant committed solution. So I am glad that the administration is on board with the idea of an expanded FHA plan, but I think your plan, Mr. Chairman, does a lot more to help a wider range of homeowners than some of what the administration is talking about.

And I will just take a moment just to remind us again about what Senator Carper was saying. This is far beyond the individual. It is about all of us. At the end of the day, it is about all of us. We had an economy that lost 80,000 jobs in March; the unemployment rate rose to 5.1 percent; the housing crisis has already subtracted 1.2 percent from the GDP growth; and home prices declined for the first year since the Great Depression. The first year since the Great Depression.

We have $460 billion in adjustable rate mortgages scheduled to reset this year, which means that the number of padlocks on doors are only going to grow. And there were 8,000 filings for foreclosure per day in the month of February; 3 million mortgage loans are expected to default this year and next; and of these, 2 million are expected to result in foreclosures.

And, finally, yesterday RealtyTrac reported that there was a 5-percent increase in foreclosure filings last month and a 57-percent increase from last year. And their report shows that one in every 538 American households received a foreclosure filing last month. One out of 538.

Mr. Chairman, we need to do everything that Senator Shelby and you have talked about in terms of protecting so that we do not find ourselves in this circumstance again. But the urgency of the moment is now, and I hope that, you know, we can convince the administration to move quickly and more significantly than it has talked about today, and we look forward to hearing the panel.

Chairman DODD. Thank you.

Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. I typically do not make opening comments, but there has been so much, I will just follow up on Senator Menendez and say that I agree with him. I think his last sentence was dead on, that the administration does have a plan, and I hope that they will move quickly to implement it. I read it last night. It actually makes a lot of sense.

I just would say that, in general, our efforts so far have been incredibly clumsy. We have spent $168 billion with our first stimulus package, which is a boon for Walmart and Sears and others, but not for the economy in general. And this last effort, to me, while I applaud the bipartisan efforts, it was, again, incredibly clumsy, and we are spending lots of money doing things that have nothing to do with the problem. And I applaud you today for having a hearing that is surgically focused on the actual problem. But I hope as we move through this we remember how clumsy our efforts can be legislatively and that we encourage efforts by the administration that can move swiftly and actually do things hopefully that make more sense and do not have long-term lingering problems for others to pay for down the road.

So this is a surgical meeting. I thank you for this. Yesterday's hearing to me was outstanding, and I look forward to some good discussion today. But I hope we will keep in mind and look back at what we have done over the last couple months knowing that we have not even come close to hitting the target, and sometimes when we do things legislatively, that is what occurs.

Chairman DODD. Well, I could not agree more. We certainly have been trying to hit that target, and it is awfully difficult sometimes to get all the players aiming in the same direction.

Senator Tester, any comments.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Yes, well, thank you, Mr. Chairman. The questions that Senator Shelby asked are good questions. I hope you submit them so we can get answers for them.

Truthfully, I know some of them are global and some may not be able to be answered, but the truth is that for that 2 or 3 minutes you asked questions, they are all critically important, and they are questions I want to know, too.

I think it is interesting because, you know, we talk about folks, if they can afford to get into a home, and then you have got bankers that allow them to get into a home on an interest-only loan with no down. So who is really at fault here? And I really revert back to personal experience.

When I moved here 16 months ago and we were looking to buy a house instead of renting, for obvious reasons, I was offered a no-down, interest-only loan, and I was very tempted. If I had been 20 years old, I would have probably jumped on it. It is goofy. It is goofy that they would offer that. And it is also goofy that you get checks in the mail for 5,000 bucks and you just go put them in the bank and you have got money. And if you are hard up, you do it.

There are people that are responsible for this, and I want to—and I do not think the administration has done any kind of job at all over the last few years, having any oversight of what is going on in the industry. And it is very disturbing to me. And I do not know if what we have done is clumsy or not. I have not been totally happy with it either, Senator Corker, but the fact is that when Bear Stearns got into trouble, it took 3 days. And I just wonder how much due diligence was done there.

Thank you, Mr. Chairman.

Chairman DODD. Great question. Ninety-six hours, moved pretty fast, put $29 billion right on the block pretty fast, and no collateral last, except hoping the assets there are going to turn out to be worth something down the road. And here we are 1 year later, having sat in this very room with all the stakeholders, trying to get them to do something on this damn thing, and nothing happened. According to Moody's, 1 percent may be workouts. Nothing. And the administration sat back in August, and all they wanted to talk about was the debt ceiling when we had the meeting on this issue. And using their language, it was "contained."

So clumsy is what I am getting from the administration in not responding to this because we are failing to address what is going on here, and it is getting worse, daily getting worse. So my hope is—and we are going to be able to act fairly soon on some of these ideas, and simultaneously obviously go back and try and figure out as much as we can about what happened. And that is clearly an important function of the Committee. But that is not going to be—we are not going to be judged historically by just examining what happened if, in fact, in the process we do not do something to short-circuit this. And if we do not do that, then history will indict

us if we end up with an economic mess on our hands that takes a generation to correct. And I am worried that is going to be the case.

So, with that, we welcome our witnesses this morning. We are delighted to welcome the Honorable Brian Montgomery, Assistant Secretary for Housing, Federal Housing Commissioner. Mr. Montgomery formerly served as Deputy Assistant to the President in the Cabinet of the Secretary before coming to HUD. His duties included oversight of FHA's $400 billion insurance portfolio and HUD's various regulatory responsibilities.

Arthur Murton is Director of the Division of Insurance and Research for the Federal Deposit Insurance Corporation. Mr. Murton has a Ph.D. in Economics from the University of Virginia, served at the FDIC since 1986—22 years. The Division of Insurance and Research directs the FDIC's efforts in banking research and policy development, and let me just say Sheila Bair wanted to be here, but there has been a death in her family, and we extend, all of us do, our deepest sympathies to Sheila. She has been a wonderful public servant, has been before this Committee many, many times. We welcome you here today, Mr. Murton, but please extend our condolences to Sheila.

Mr. MURTON. Thank you. I will do that.

Chairman DODD. Scott Polakoff is the Senior Deputy Director and Chief Operating Officer of the Office of Thrift Supervision. He joined OTS in 2005 after serving the FDIC for over two decades. The OTS is the primary regulator of Federal and State chartered savings associations.

We thank all three of you for being here this morning, and we will begin with you, Brian. Thanks for coming before the Committee.

STATEMENT OF BRIAN MONTGOMERY, ASSISTANT SECRETARY FOR HOUSING/FEDERAL HOUSING COMMISSIONER, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. MONTGOMERY. Thank you very much, Mr. Chairman and Ranking Member Shelby, for this invitation, and I want to say I think the time is now for some clear vision and some wise policy as we go forward.

I do want to say I am confident that we can find some common ground to address this housing crisis, given our mutual interest in breaking the cycle of foreclosure. You and I agree that what the Nation needs is a solution that restores desperately needed liquidity for the credit markets and some price stability to the local real estate markets, and I know that we all want to find a way for FHA to help hundreds of thousands of Americans keep their homes and certainly avoid foreclosure.

I believe we must help responsible families and communities in need without transferring risks and costs that should be borne by the private sector to the taxpayers. In fact, I believe most Americans want to protect homeowners who play by the rules. They don't want to have to pay for the risky financial behavior of others, 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 on the taxpayers.

The taxpayers do not want us to Federalize the housing market, which would be unwise economically. I believe FHA should remain true to its mission. 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 even perhaps prolong the correction.

I will say this. For more than 2 years, the administration has suggested legislative ways to improve the agency's ability to fulfill its mission to help low- and moderate-income and also first-time home buyers who are not served by the conventional mortgage market. The administration continues to urge Congress to reach agreement on a bill to modernize FHA so that the President can sign it into law.

Mr. Chairman, in the meantime, FHA has been able to use its administrative authority to help hundreds of thousands of Americans refinance their home loan. In August of last year, the President introduced an effort known as FHASecure to help more Americans facing foreclosure refinance into a safer, more secure FHA-insured loan. Since then, close to 160,000 families have been able to refinance with FHA. We have always said that we are open to further expansion of FHASecure, but done so in a responsible way.

Thus, last week at a hearing before a House Financial Services Committee, I announced some further administrative steps that will extend FHA opportunities to more homeowners that will help break the cycle of foreclosure. These efforts, using current regulatory authority, are targeted to distressed homeowners struggling to make their current mortgage payments and have no place to turn to refinance their homes as they continue to lose value.

And our efforts will not create an unacceptable level of financial risk for FHA. I believe that some of the Congressional approaches often have unforseen consequences. For example, we believe mandatory write-offs of all existing mortgage debt will severely limit participation by existing lien holders. In addition, home buyers who speculated with a high-risk, high-leverage product would under this bill be rewarded with the deed to an upper-end house for a cost well below its long-term value. They can live in this house and later sell it for a substantial profit at the expense of the investors, who will take the write-down losses. The proposal does create significant inequity for the neighbors of such speculators.

Also, the equity-sharing arrangements in this bill, we think are wrongly directed. The equity arrangements to prevent windfall profits to homeowners should not benefit the Federal Government, but the existing lien holder to minimize their losses. To be blunt, this is not our money.

As well, creation of a new fund and board to expand the existing cap is redundant and, we believe, unnecessary because the existing FHA framework could achieve the same goal and much faster.

Finally, Mr. Chairman, establishment of new GSE and suspension of the existing goals should be handled by HUD alone, the agency most familiar with the process. We believe adding extra cooks to that kitchen will unnecessarily complicate a process that we believe is currently working.

I should add that the administration opposes any provision which will provide billions of dollars in loans or grants to States and local governments, whether through the CDBG program or other programs, for the purchase and rehab of vacant foreclosed homes. We believe in addition to being extremely costly, such a program would constitute a taxpayer bail-out of lenders and speculators while doing little to help keep struggling families in their homes.

These are my initial thoughts about the bill. Let me say in closing, I will reiterate that. We do have some common ground to explore here and I want to say I look forward to working with you and the entire committee to do just that. There is a lot riding on this, Senator and Mr. Chairman. Thank you.

Chairman DODD. Thank you very much, Brian, for that, and we look forward to your ideas and thoughts in exploring some of the differences.

Mr. Murton.

STATEMENT OF ART MURTON, DIRECTOR, DIVISION OF INSURANCE AND RESEARCH, FEDERAL DEPOSIT INSURANCE COMPANY

Mr. MURTON. Chairman Dodd, Ranking Member Shelby, Members of the Committee, I appreciate the opportunity to testify today on behalf of the FDIC.

The problems we face in the housing and credit markets were caused by a complex set of interrelated concerns. The FDIC is concerned that we face a continuing cycle of default, foreclosures, declining home prices, and uncertainty, thus leading to potential for further losses, preventing recovery of the credit markets, and impairing the performance of the U.S. economy. Avoiding this result will require well-designed approaches to help distressed borrowers and to restore secondary market liquidity.

No single solution can fully address the circumstances confronting us. Proposals addressing the current problems in the mortgage markets will 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 a large number of foreclosures that would adversely affect other homeowners, other communities, and the broader economy.

The FDIC has advocated systematic voluntary loan modifications to deal with poorly underwritten and unaffordable loans, particularly in the subprime market. While some progress has been made, the pace has been too slow to achieve the results that we were hoping for and to contain the broader harm to our communities and the economy. As Chairman Bair has stated, we are at a point where we need more intervention and it probably will cost some money.

In the remaining time, I would like to make a few comments about the Hope for Home Owners Act of 2008. The proposal by Chairman Dodd addresses many of the principles the FDIC considers necessary for an effective program. It restructures troubled mortgages into loans that should be affordable and sustainable over the long term. It requires that investors recognize current

losses while preventing borrowers from being unduly enriched if home prices appreciate. It uses existing government and market structures, which should allow the program to be implemented quickly. And it includes a financial cushion to help insulate the FHA and the taxpayers from losses.

Still, there are some specific issues that need to be addressed. A major obstacle to refinancing many troubled first mortgages is that a significant number of them are subject to second liens. Resolving this issue is essential.

A second concern is whether the FHA in the short-term will have the capacity to run the program.

Third, there is the potential for adverse selection. The concern here is that investors will have economic incentives to cherry-pick the better loans and push the weaker loans into the FHA program, thereby increasing the cost.

A final issue relates to the lack of financial incentive for servicers to modify loans.

In addition, my prepared testimony contains a few suggestions that go beyond the scope of the bill before the committee.

So in conclusion, the FDIC supports long-term solutions that fairly share the costs and risks of modifying or restructuring loans, that use existing government and market structures, and that mitigate the potential exposure to taxpayers. The FDIC is committed to working with Congress and others on solutions that address the immediate problems and that look to the future.

Thank you, and I would welcome any questions the committee would have.

Chairman DODD. Thank you very much, Mr. Murton.

Mr. Polakoff.

STATEMENT OF SCOTT M. POLAKOFF, SENIOR DEPUTY DIRECTOR AND CHIEF OPERATING OFFICER, OFFICE OF THRIFT SUPERVISION

Mr. POLAKOFF. Good morning, Chairman Dodd, Ranking Member Shelby, and Members of the Committee. Thank you for inviting me here today to testify on behalf of OTS on preventing home foreclosures in America.

We are in the midst of a stressed real estate environment. Home sales have deteriorated sharply, with sales down by 36 percent since 2006, resulting in nearly a 10-month inventory. An increasing number of borrowers are having difficulty making their mortgage payments. Of the $11 trillion in mortgage loans outstanding, approximately $1 trillion are subprime loans. As of January 2008, 21 percent of subprime borrowers are delinquent, compared to 14 percent 1 year ago.

Foreclosure data suggests an increasing number of home owners are losing their homes, as the rate of foreclosure on all mortgage loans has doubled in the past 2 years and for subprime loans has risen to 9 percent from 4 percent in the 12 months ending January 2008.

Adding to the problem is the unprecedented home price depreciation. With home prices down 10 percent from their peak in 2006, approximately nine million home owners are expected to have no or negative equity in their homes. Our observation is that numer-

ous borrowers who would benefit from refinancing their mortgages can no longer qualify, as the equity has disintegrated over the past years.

I should point out that a significant concentration of these nonperforming loans resides in private-label securitizations. A private-label securitization has many stakeholders. The borrower, the investor, trustee, and the servicer all play critical roles in this secondary market funding vehicle. Any proposal to help prevent avoidable foreclosures should consider the interests of each of these components and opportunities to align various interests for the good of our housing economy.

As you know, OTS announced its foreclosure prevention proposal in February of this year. Since then, we have been meeting with other financial regulators, major mortgage servicers, the American Securitization Forum, and other industry experts in an attempt to refine our proposal to assist with these efforts. These meetings, particularly with the servicers and investors, have given us insight into what I consider to be the key question at hand, and that is how to provide the right incentives to all of the stakeholders.

If the proposal is too rich to borrowers, then we risk moral hazard. If the proposal ignores the interest of investors, then we risk inactivity by servicers. And if we ignore the legal documents, specifically the pooling and servicing agreements, then we risk excessive litigation and potentially impair future liquidity in the secondary market. But if we don't create an effective tool, then foreclosures will continue and the negative impact on neighborhoods and communities will be severe.

As you know, the OTS plan has a good deal in common with the Chairman's bill. Both seek to prevent foreclosures by refinancing the mortgages of distressed borrowers with loans guaranteed by the FHA. Both proposals suggest a conservative loan-to-value ratio based on the home's current fair market value. We recognize that this current fair market value may be less than the principal owed on a loan due to home price depreciation. Under the OTS plan, the holder of the original loan would sustain a loss and receive a negative equity certificate for a sizable portion of the difference between the outstanding loan amount and the short refinance amount. The original loan holder could recover an amount up to the full value of the negative equity certificate when the home is eventually sold.

I should point out that we have refined our proposal to allow the home owner to share in this negative equity interest as an incentive to stay in the home, maintain it, and perhaps even make improvements to get the best possible price upon resale. This borrower incentive is another important part in searching for the proper equilibrium of interests.

Recently, we have heard stories where the second mortgage holder has prevented a borrower from entering a short refinance by refusing to subordinate its lien interest. It seems worthy to explore the possibility that such second mortgage holders could also share to some small degree in the negative equity certificate as an incentive to subordinate their position for a refinance opportunity.

Last, there are two key components of our proposal that deserve mention. First, this vehicle would apply only to situations where default is reasonably foreseeable. While it has the ability to assist

borrowers who may be underwater in their mortgage, it is not intended to aid borrowers who have the ability to repay but lack the willingness to repay.

Second, this model is intended to help owner-occupied borrowers, not investors.

We recognize that there are multiple causes for real estate stress and there need to be multiple tools available to work through this crisis.

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

Chairman DODD. Thank you very, very much, and I thank all three of you for your comments. I should have said at the outset, if I didn't, any supporting data, materials you want the committee to have as a part of the testimony we will certainly include as part of the record.

I will put 7 minutes on here and see if we can't hold to that so we give everyone who is here a chance to raise some of these very important questions that members have.

Let me, if I can, just start out quickly with you, Mr. Montgomery, obviously to try to get as much information as we can about what is working and what is not working. And again, I want to emphasize the point, I know a lot of people are trying to figure out what best to do in all of this, and I welcome that and I am deeply appreciative of the various ideas that have been surfaced.

Let me state as clearly as I can, there is no ideological position here. I am trying to be as practical as I can as to what can work, make a difference. And so I am less interested in people's ideological framework than recognizing there are moments when an intervention is necessary. Ideally, I don't like it. I would like the market to work. And if the market can work, there is no reason for us to act. But when the market is not working, then it becomes incumbent upon us, I think, to try and figure out a responsible way to intervene intelligently, thoughtfully, and responsibly, obviously understanding at the time you are never quite sure what is going to happen, but you hope you are smart enough that you are going to be a positive influence on it.

But to do that, you have got to know what the data is. I am looking at an article that was entitled, "HUD Acknowledges Inability to Help Many Borrowers." This was an article that appeared about a month ago, and the Director of FHA's Office of Single-Family Program Development said that there had been only 1,500 FHA-secured financings. From March 1 to the 15th, HUD reported that just 242 loans were made for delinquent borrowers, or just 17 loans per day.

I mentioned earlier we are getting some, according to Track Realty, in the neighborhood of 7,000 to 8,000 filings a day and as many as 1,000 of those 7,000 or 8,000 are actually going into foreclosure. At least those are the numbers we are getting on all of this.

So instead of 17 a day, as opposed to the numbers we are looking at—let me ask, first of all, the two other witnesses. Do you agree with that general overview here, that the program is not—FHASecure, while it is a good idea, it is not addressing the magnitude of the problem. Is that your conclusion, as well, as you have looked at this issue?

Mr. POLAKOFF. Mr. Chairman, I wouldn't be prepared to say that at this point. As we reach out to the servicers, we understand that the servicers themselves are modifying a number of loans in an attempt to do the right thing. Borrowers are using FHASecure as a vehicle. There still seems to be an incredible difficulty to reach a number of borrowers as they approach default and a foreclosure situation, sir.

Chairman DODD. How about you, Mr. Murton?

Mr. MURTON. Well, I think as I said in my statement, I think as Chairman Bair said, we are at the point where we do think more steps are needed. We think the efforts so far have been important, but we do think that more may be needed.

Chairman DODD. Well, in your testimony, Mr. Montgomery, you state that FHASecure and HOPE NOW initiatives have together helped more than 1.3 million home owners. I would like to get that data, if I can, or the committee would, for the record that breaks out exactly how many borrowers are getting repayment loans and modifications, what kind of repayment plans and modifications they are getting. All of us hear, I think, that too many loans are being reclassified as modifications where no long-term interest rate freezes are involved or other considerations. The word "modification" is being rather used loosely, and it would be very helpful if we could at your earliest convenience here to get us the data that supports that conclusion of 1.3 million.

Do you want to add any comments here in terms of the concerns I have about them?

Mr. MONTGOMERY. Yes. Absolutely, Mr. Chairman. Thank you. When we announced FHASecure on August 31——

Chairman DODD. I point out, by the way, the industry itself has raised some concerns in the press about what they call cooking the books on these numbers, so——

Mr. MONTGOMERY. Anybody can look at our books who want to, sir, any time, any day. Let me just say that when we rolled out FHASecure, again, we are an insurance company. We needed to have a measure of response backing our actuarial soundness. But we did say going forward that we would make improvements as we saw fit.

There have been 163,000 mostly subprime borrowers who are heading toward the slippery slope of delinquency—we know this because they tell us—who had never even heard of the FHA. Remember, for many years, and your staff will attest to this, FHA, I think a lot of people thought we were the Federal Highway Administration. We are almost an afterthought for many borrowers. A lot of publicity around the announcement. Again, borrowers tell us this. They thought they had no other option.

So I will say this. We way overestimated the number who would come in delinquent, and I will get to that in a second. We way underestimated the numbers that would come in current. By the end of the fiscal year, we believe we will have 400,000 borrowers—remember, these were not FHA borrowers—that will refinance through a safe and secure FHA loan.

Now let me fast-forward to last week. Moving forward, we wanted to make some more improvements to FHASecure, again coming at it from the sense of delinquencies, keeping our debt-to-income

ratios and the like. We think we will add another 100,000 to that number. Remember, a lot of these folks were never going to qualify anyway. They had no document loans. They had stripped out a lot of the equity in their homes. So going forward, I think a lot of those families who refinance will disagree that they have not been helped.

Chairman DODD. Well, again, I think getting the data here would help us get a better picture on all of this.

One of the things being raised, a concern about it, is, of course, that we are protecting taxpayers. Obviously, all of us want to do that. When this program or something similar was tried years ago, it actually produced a modest amount of income for the Federal Government in those days, in 1920s, 1930s dollars. We are not looking to make money off this, but obviously we want to avoid having great exposure for the American taxpayer, as well, that has been raised by many, including Senator Shelby and others.

And one of the ways we try to protect the taxpayer in this plan—the three ways we try to do it, I would like to know how you feel about these and if there are any other ideas you would have that we ought to include as part of the proposal.

One, it increases the maximum up-front and annual premiums in the proposal. It calls for FHA to share in future appreciation. So you are getting resources back to the program. And it limits the maximum loan-to-value of the new loan to 90 percent of the current value of the property, something Mr. Polakoff addressed.

Do any of you have any other additional factors or reactions to these ideas and is there anything else you would add? How about you, Mr. Montgomery?

Mr. MONTGOMERY. I would say on the LTV, again, sir, there is some common ground here. I can't stress that enough.

Chairman DODD. Yes.

Mr. MONTGOMERY. We think there needs to be an incentive for the current lien holder as part of those agreements that were referenced earlier to want to do the write-off down to some certain number. I think a mandatory complete write-off, where the FHA refinance is accepted as payment in full, I don't know that you will get the participation that you are looking. We think by coming at it a little differently that FHA steps in, there is a second lien for a part of that charge-off, we think is a more prudent approach. Ninety percent LTV loans perform very well for FHA.

I would also say on the debt-to-income, I know that you give that authority to a board——

Chairman DODD. Yes.

Mr. MONTGOMERY [continuing]. Which again we, speaking for our excellent career staff at FHA, believe strongly we have that expertise. But we feel very secure in keeping those debt-to-income ratios the same, and I know you would have this board do that, 31 being the front end, 43 being the back end.

Chairman DODD. Right.

Mr. MONTGOMERY. On the shared equity component, again, as I mentioned in my oral statement and the written, we were not party to that original transaction. This is not FHA's money.

Chairman DODD. Yes.

Mr. MONTGOMERY. I think we share in the goal that we want to keep that borrower in the home so they don't experience some windfall profit. We think the 90 percent with the soft second supports that. But we could also have some sort of recapture provision, some sort of resell restriction to perhaps accomplish the same thing.

Chairman DODD. I agree with that. That is not a bad idea.

Mr. Murton.

Mr. MURTON. Yes. In our written testimony, we did mention that perhaps increasing the fee from 3 percent to 5 percent, or in that direction, may be important. We are concerned about making sure that the government is protected to the extent possible. So I think there may be room for discussion on that. We do recognize that you do have to provide incentives for the investors to participate.

Chairman DODD. Right. Exactly.

Mr. POLAKOFF. Mr. Chairman, we would urge very strongly consideration that the negative equity certificate or the potential of sharing upside appreciation reside with the original loan holder, potentially also with the second and with the borrower. Whether 90 percent LTV, whether that 10 percent cushion is the right amount, the key here for these FHA refinance, we believe, is insured financial institutions are going to be the ones that underwrite these loans. It should be fully documented, properly underwritten, with a 10-percent margin. We believe they should be safe and sound loans.

Chairman DODD. Yes. Well, in fact, on the incentive idea, I think there is some real value in that, as well, striking that balance, because this is voluntary, and to the extent you want both the investor and obviously the borrower—the incentive of the borrower is there. You get to stay in your home. But the incentive for the investor to step up and say, I am willing to take that haircut and do this, I think you have got to have a proper incentive in there. It gets to the issue rather well of the safe harbor provisions, which I will come back in a later round since we have already gone over the time here. But I appreciate your comments on that.

Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Mr. Montgomery, you stated in your testimony that some ideas stretch FHA beyond its role or ability to serve the American people appropriately. Today, I will ask you, does FHA have the institutional capacity in terms of expertise, staff numbers, available funding, among other things, to be able to handle the proposed increases in its activities?

Mr. MONTGOMERY. Well, not to get sideways with the budget folks, I guess the only good news in the fact that we are still waiting for FHA modernization is we have been able to take 2 years——

Senator SHELBY. Some of us serve on the Appropriations Committee, too, so if you wouldn't mind——

Mr. MONTGOMERY. Sorry, Senator. That we have been able to upgrade our systems, even though their average age is about 18 years. So yes, we do need some systems upgrades.

Senator SHELBY. Which is going to cost money, that capacity.

Mr. MONTGOMERY. Yes, sir.

Senator SHELBY. OK. Would you explain to the committee what you believe constitutes underwriting flexibility? As some might say, underwriting flexibility is a euphemism for the loose underwriting standards that led many to present difficulties in the mortgage markets. What do you mean by underwriting flexibility?

Mr. MONTGOMERY. Well, I will agree with some of what Senator Tester mentioned before. It was almost free money, these no docs, income-stated asset. Remember, FHA——

Senator SHELBY. That is asking for trouble, isn't it?

Mr. MONTGOMERY. Absolutely, sir. That is part of why we are in this predicament we are in, and FHA doesn't do that. We have this crazy notion you have to prove your job history. You have to verify your income. We have rigid debt-to-income ratios that we are not going to change.

Senator SHELBY. Mr. Murton, some have suggested that Congress should set up a board to oversee an expansion of FHA. On that board, some would say, should sit the FDIC, the Treasury, and Housing and Urban Development Secretary. Would you tell the committee here or in writing later what unique expertise the FDIC posses in the area of mortgage insurance? I know that is part of your portfolio, a big part. Go ahead.

Mr. MURTON. Yes. I would be happy to provide a fuller answer in writing, but I think that when you look at our experience as safety and soundness supervisors, as supervisors for consumer protection, I think we have experience, a great deal of experience in the mortgage markets. And then in our capacity as the receiver of failed institutions, we have people who have dealt with these problems, who have tried to work out loans with borrowers, who have tried to avoid foreclosures and who have seen the effects of these kind of problems on communities and the economy.

Senator SHELBY. Mr. Murton, you also mentioned in your testimony that one of the first principles for solutions is that the solution be sustained over the long term. In other words, doing something just for expediency generally won't work. Do you believe that it is a sustainable solution to write down a mortgage and refinance it when many housing markets are likely to see future price declines of ten, 15, 20 percent? In other words, where is the bottom? Are we rushing too soon? Where are we?

Mr. MURTON. I don't know that anyone knows when we will get to the bottom. I think that we have borrowers who are not in affordable mortgages and I think they are facing the decision of whether to end up in a foreclosure, and I think that needs to be addressed and that we need to address that sooner rather than later is our perspective.

Senator SHELBY. Mr. Montgomery, appraisal controls. A critical component of all of the write-down plans that have been presented is the integrity of the appraisal process. Lenders still will have a strong and clear incentive for properties to be over-appraised in order to shift as much risk as possible to the government. HUD's Inspector General recently reported that FHA did not have adequate internal controls over its appraiser roster. What steps, Mr. Montgomery, is FHA planning to take to minimize the adverse impact of inflated appraisals on the Mutual Mortgage Insurance

Fund? I think it is very important that we get realistic, honest appraisals.

Mr. MONTGOMERY. Absolutely, Senator. I agree 100 percent on that. We have had roughly 1,400 or so sanctions against appraisers in the last 3 years, and, in fact, stood up a program that would help using a risk analysis identify appraisers that we were getting high default rates, things of that nature.

Back to your question. On the stimulus package, the increased loan limits for FHA, for that jumbo FHA product, as some are calling it, we just put out guidance a week-and-a-half ago that we are going to require two appraisals for those. Although remember, an appraisal is just an opinion of value. We are considering doing the same going forward on this FHASecure expansion.

Senator SHELBY. Mr. Montgomery, were FHA to lower its underwriting standards in order to serve more borrowers, the most likely result is an increase in losses to the Federal Housing Administration, which could ultimately be borne by the taxpayer. What level of delinquencies and losses are you projecting for your planned expansion of the FHASecure program?

Mr. MONTGOMERY. Well, by doing——

Senator SHELBY. Have you done some modeling there?

Mr. MONTGOMERY. Well, sir, we have done modeling and more modeling. But there is about a five-legged stool here, and in the interest of time, I will be very brief.

Senator SHELBY. That is OK.

Mr. MONTGOMERY. We need to do some sensible risk-based pricing, and this is something that was in the original FHA bill a year ago—excuse me, 2 years ago. The seller-funded downpayment assistance, which I know the Senate has included prohibitions on that twice, that is, as you know, a lot in the predicament that we are in, long-term financial solvency. But remember, on our proposal for the delinquencies, if you have one 90-day or three 30-day delinquencies, that now has a 90-percent LTV requirement. That is a tighter restriction, because our existing product is only 97 LTV. And, again, historically, those 90-percent LTV products perform very well for us from an actuarial standpoint.

Senator SHELBY. Mr. Chairman, I just want to wrap this up, if I can, in a few seconds. In my opening statement, I asked several questions that I believe this Committee—the Committee on Banking, Housing, and Urban Affairs—needs to have answered, and I commend the Chairman for his comprehensive approach to this. Before we can proceed to crafting good legislation—and I am going to go over this again—how many of these households made minimal or no downpayments on the properties they hold? That is something we need to find out, and perhaps some of you can help us with. How many of these households did a cash-out refinance on that same property and now face difficulty paying the higher mortgage costs? How many of the households have poor credit scores and have significant credit card debt—in other words, are overburdened? How many homeowners used exotic mortgage products, gambling on the ability to refinance in future years? You know, betting on the ever rising stuff out there. I do not know the answer to that, but I think that is all part and parcel of our dilemma here facing that. Do you disagree with that, Mr. Montgomery?

Mr. MONTGOMERY. No, sir. I agree with that statement.

Senator SHELBY. Mr. Murton.

Mr. MURTON. I agree with that.

Senator SHELBY. Do you agree?

Mr. POLAKOFF. Yes, sir. It is the question as to whether the borrower was a victim or an accomplice.

Senator SHELBY. And sometimes a victim, sometimes right in there with them?

Mr. POLAKOFF. Yes, sir.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator Shelby. And, again, I have said over and over again that I think if you break these borrowers down to three groups of people, you have got those that were speculators, and there is nothing that I am proposing that is designed to provide any relief for the speculator. I feel badly for them, but they are not included. This has to be owner-occupied so you are not sitting there buying properties that you do not live in that you are just trying to make a buck off of.

The second group of people that, frankly, never would qualify under any restructuring you could provide for would not be able to fit into this, and we cannot, tragically—maybe there are some other ideas that people have on how to help those people, but I cannot see how we can necessarily fit them into this idea we are talking about. What we are talking about is that constituency, those groups of people who are in situations that they can afford to stay in there with a workout, that will allow the investor to get something back so they do not lose everything, so that neighbors will not be adversely affected by foreclosed properties in the neighborhood. They may have, you know, chosen or should have chosen a wiser course to follow but, nonetheless, are in the situation they are in, and the moral hazard is not only—should not only be focused on whether or not that individual should have been more conscious of the kind of problems they could get into, but also the moral hazard is to the other people that will be adversely affected if we do not act and do something about this as well. And that is really the target audience we are trying to get at. The benefit is obviously to keep people in their homes where we can. The added benefit is, of course, that enough transactions will occur that you can actually determine what the floor and the bottom is. That may be the more important point from a macroeconomic standpoint so that the credit crisis begins to lessen and capital begins to flow and the problems begin to address themselves not only in this area but in other areas of the economy that are feeling this as a result of this particular problem. That is the idea behind this more than anything else, and getting at it.

So I—and we know from the Wall Street Journal study, which I do not know how accurate it was, but there were some 60 percent of these borrowers that would have qualified for prime loans at a lot less cost to them than these subprime deals that they were talked into. And, again, you know, it is the relation of doctor and patient. I mean, I probably should ask all the right questions of my doctor before he operates on me. But, candidly, I am not a doctor. And I am sitting there and I am relying on someone across that table from me in a sense who is holding themselves out as a finan-

cial adviser to—probably I am anticipating more than I should, but when a doctor does not do their job, there is something called medical malpractice, and we do not turn to the patient and say, "You should have asked better questions before you got into this." In a sense, that same analogy can apply to some degree here; when you are sitting across that table, it is not exactly a level playing field in many ways. And I think to sort of suggest as such is to misunderstand what occurs when people are trying to get into a home, trying to stay afloat. Most of these are second mortgages, as we know, not first-time homebuyers. And people are underwater financially. There are two or three incomes. They are using credit cards. The Chairman is absolutely correct. We know now—what is it? I think something—I was stunned yesterday that a quarter of students are paying for their student loans through credit cards. The average is almost close to $10,000 per household in credit card debt and obligation. So it is a mounting problem, the consumer debt issue, and that is not going to go away here, and I do not know if we are ever going to find the exact numbers of the economic profile of that individual caught in that situation that today is finding themselves facing foreclosure and moving out of their homes.

So I want to make clear that is what we are targeting, trying to get to that audience that has the benefit, obviously, of keeping their family there, stabilizing that neighborhood, property taxes coming in, as well as not allowing this problem to spread throughout that neighborhood and getting the spiraling effect where foreclosures beget more problems beget more foreclosures, and you get that spiraling down problem, and the problem gets a lot worse and a lot more costly in many ways.

And, again, anyone who claims they have cornered the wisdom on all of this or knows exactly the right thing to do, you ought to be immediately suspicious of them. I certainly do not. I am relying on smart people who have been through this and understand it, trying to come up with a formulation here that could make some sense and work for us. That is my job here, the practical applications of trying to short-circuit a problem that is growing worse.

Senator Menendez.

Senator MENENDEZ. Mr. Chairman, I think Senator Carper is next.

Chairman DODD. I am sorry. I apologize. You are exactly right. My apologies.

Senator CARPER. Thank you, my colleague and neighbor.

Chairman DODD. You have moved in already. That was pretty quick.

[Laughter.]

Senator MENENDEZ. Just a summer home.

Chairman DODD. Just a summer home, OK.

Senator CARPER. Again, we appreciate your being here and your testimony today.

Mr. Montgomery, right at the end of your testimony, you said these words. You said, "In conclusion, 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 am going to ask each of you to talk about the common ground.

Mr. MONTGOMERY. Do you want me to go first?

Senator CARPER. Why don't you go first?

Mr. MONTGOMERY. I would say first and foremost I think we agree a lot of folks are in the right house but the wrong mortgage. No one is promised instant equity when they buy their home. There is also no doubt that we have not had a nationwide, almost, with some small exceptions, decline in home prices like we have seen recently.

Going forward—and I agree with the Chairman and the Ranking Member. I think we all agree on who we want to help and who we do not want to help, as unfortunate as those other circumstances may be. So we think going forward if there is some sort of writedown to a number with a new appraisal, perhaps two appraisals, that FHA—and there is a reason we have an FHA, and this is a good one, I think—can insure a portion of that loan, recognizing that this does not happen in a vacuum. There are servicing agreements, pooling agreements. There are investors. There are these second liens, which a lot of these were piggyback loans. Everybody has a stake in this if we are going to do the ultimate thing, and that is, keep the home and the borrower out of foreclosure.

So that is why we think, as well intentioned as doing this mandatory write-off is, I would just question how many lenders and servicers would want to participate versus what we want to do is put that option that exists today to have that soft second. It does not accumulate interest. There are no payments made on it. But it is out there so that some portion of that debt is resolved when the home is refinanced or sold, and ultimately we will turn this corner, whenever that may be, and prices go back up. And I think that is something we all—maybe not to the pace that we just saw recently, but I would say that is certainly some common ground. We shared this with House Financial Services Committee as well.

Senator CARPER. All right. Thank you.

Mr. Murton, where do you see the common ground?

Mr. MURTON. Well, I think in our testimony we laid out four principles that we would like to see that people——

Senator CARPER. Go ahead and restate those. I saw those in your testimony. State them again.

Mr. MURTON. That people be put in sustainable mortgages; people who can be in those should be in sustainable mortgages. The burden should be shared appropriately, that parties should take—third parties are going to have to take losses, and the burden will have to be shared.

Senator CARPER. Who would you include among those third parties?

Mr. MURTON. Can I come back to that in a minute, please?

Senator CARPER. Sure.

Mr. MURTON. Just let me get through—I am sorry. We would like to see it use existing structures, market and Government structures, so it can be done quickly. And we would like to make sure that we limit the liability to the Government, and I think there is common ground on most of those.

And I think going back to the second one, that is where there may be more work to be done, because the burden sharing of this is quite complicated to figure out. It is absolutely clear that you

need to provide the appropriate incentives so that investors will encourage the participation on their behalf by servicers. That is absolutely critical. It is also critical that you protect the Government's interest in this if the Government is going to provide funding. And I think finding the right sharing of those arrangements is one of the trickier issues.

And then, finally, I think there is common ground or agreement that dealing with the question of second liens is going to be a complex problem, and we need to figure that out.

Senator CARPER. All right. Thank you.

Mr. Polakoff.

Mr. POLAKOFF. Senator, we have to find ways to prevent avoidable foreclosures. Not all foreclosures are avoidable. There are multiple tools right now for servicers to consider. This bill offers another tool.

I would say that our conversations with servicers suggests that servicers are trying to do the right thing, trying to reach out to the borrowers who are in financial distress right now. The common elements along those lines I think fit with much of what I heard today.

I go back to the discussion that I think is very worthy of if a servicer is going to take a significant write-off in allowing the borrower, the distressed borrower, to be able to refinance, whether it is with an FHA guaranteed product. I also think there is a benefit to talk about the role of private mortgage insurance with loans underwritten at 90 percent with insured financial institutions. But the question that I would submit, the topic that deserves more discussion potentially is who can benefit from the home price appreciation, which will return at some point.

Senator CARPER. I was talking with one of our leading bankers in our State, and we were talking about, among other things, the amount of money that a mortgage servicer is paid. And he suggested to me that their take, if you will, is 25 basis points in most situations, but in a foreclosure, the mortgage servicer can realize as much as 6 times that income.

Can you confirm or correct that for me, anybody?

Mr. POLAKOFF. Well, I cannot confirm it. I certainly would not be so bold as to correct it. But I would submit that typically a servicer in a subprime portfolio gets 50 basis points for servicing that portfolio, and typically in a foreclosure process, the servicer gets—or the servicer receives any out-of-pocket costs associated with the foreclosure. All of our investigation with servicers does not reveal that a servicer benefits going through a foreclosure process.

Senator CARPER. Could anyone else comment on that?

Mr. MURTON. I am not an expert on those numbers. As I understand it, they are compensated at a higher rate in a foreclosure, but there are offsetting costs and so forth so that it may not be profitable. But the concern that we have or the point we have made is they are paid some administrative expenses to compensate for those costs in foreclosures. It is not clear they are incented to do the same for modifications and other solutions that may be preferable.

Senator CARPER. All right. Share with us your best thoughts of how we should deal with second liens or second mortgages. Everybody agrees that this may be among the stickiest wickets.

Mr. MONTGOMERY. Well, and you have probably heard some of the same concerns that we have from the investor and the lender community out there. But, yes, they absolutely have a stake going forward, and I think a lot of them will tell you there is no way they think they are going to get 70 cents on the dollar, 80, 50, 40, whatever. But the fact that there would be a mandatory discharge of all of that I think might be what would keep this from going forward.

Senator CARPER. All right. Thank you.

Mr. Murton.

Mr. MURTON. I think that we agree that most of these seconds are not worth very much. Nevertheless, they have some power over taking the loans out of the mortgage—out of the pools and restructuring them. So one thought that we had is whether we can look at ways, some other solutions that might involve working with loans in the pools under other circumstances and finding arrangements that might work there, because you may have less of an issue on the second there. But it is—we wish we could have come with an answer there, but we would like to explore that.

Senator CARPER. Mr. Polakoff.

Mr. POLAKOFF. Senator, if I could offer a thought with the seconds, because we have heard these stories, I would submit that for loan modification purposes, the seconds are irrelevant from a power perspective. And certainly they are relevant if a borrower is going to pursue an FHA loan, a refinance. But everything that we are talking about with an FHA refinance a servicer can do with a modification, and by doing so eliminates the power of the second.

So I would suggest very important to address from a refinance perspective, not necessary to address from a modification perspective.

Senator CARPER. All right. Thank you.

I think, Mr. Chairman, in your bill one other issue is the issue of a safe harbor for mortgage servicers, as I recall, that is in your bill, is it not?

Chairman DODD. It is in our bill.

Senator CARPER. Let me just ask, if I could on that, the inclusion of safe harbor as a part of what we do going forward, I think, to incentivize the—or at least to take away disincentive for the servicers to enter into these agreements. How important do you think safe harbor is?

Mr. POLAKOFF. Well, I would offer that there is a real important element of the safe harbor. The servicer must abide by the pooling and servicing agreement, which obviously has a couple very important effects. One of them is maximizing proceeds. The other is for REMIC tax purposes. In order to define a reasonable, foreseeable default, we have to be sure that whatever we submit does encounter an IRS ruling for REMIC purposes.

So I think there are a lot of very important elements to discuss with that.

Senator CARPER. All right. Thanks.

Mr. Murton.

Mr. MURTON. Chairman Bair held a number of roundtables last year to explore the complicated issues in this, and it is pretty clear that the contracts allow the servicer to act on behalf of all the investors in the group. And I think that anything that reinforces that we are very supportive of.

Senator CARPER. All right. Mr. Montgomery.

Mr. MONTGOMERY. That is a little out of FHA's realm. We are not a banking regulator.

Senator CARPER. OK. I understand.

Mr. MONTGOMERY. But I would concur with their comments.

Senator CARPER. All right. Thanks.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you. I am going to follow along the same line of questions as Senator Carper, and statements. I think that there is a lot of common ground. By the way, my "not neighbor." As a matter of fact, sitting where I sit over here, I wonder if I am part of the continental United States sometimes.

[Laughter.]

Chairman DODD. We have all been there.

Senator CORKER. I understand. I understand.

Chairman DODD. You sometimes think you are part of the press corps over there.

Senator CORKER. Well, I know these cameramen very well.

Chairman DODD. They are slipping you notes all the time, I think.

Senator CORKER. You know, I think that line of questioning was actually very good, and I know that I have shown my bias in regards to what we have done thus far on the economic stimulus efforts that have taken place. I think it has actually been my most discouraging moments here to see how we sometimes try to wrestle with issues and then come to conclusions that do not even really address the issue.

This meeting to me, much like yesterday's where I thought we had an opportunity and think we do to basically try to push the FFB into doing some things that would really solve the problem, I think has some of the same ingredients. And I think it has been an excellent hearing. And I think that sometimes the most productive things we do legislatively are not to legislate necessarily, but to place a marker out there that causes other organizations that exist to move toward that. And I think in many ways that is what you have done with your proposal, is to lay a marker out there that addresses a problem.

I think there are a lot of commonalities in the approach between the administration, the witnesses today, and yours, and I think that, you know, keeping ownership is certainly a goal that has been laid out.

It seems to me that the negative equity certificates are a very elegant way, if you will, of dealing with writing a loan down and getting a mortgage into a position that somebody can actually pay for it. And yet it does not create all those other issues of joint ownership. Many people have referred this bill to be something—referred

to this bill in a way to make it similar to what happened with RTC. But it is not. It is very different, because in that case there was a severance of ownership. The people no longer owned the property. In this case, they are actually going to be in the property. And I thought testimony we have had over the last few days where people were concerned about what do you do about home appreciation that occurs by somebody actually investing in their property, improving their kitchen, adding a garage. How do you deal with that? And then how do you deal with the possibility of the neighbor issue that was referred to earlier where one neighbor keeps their loan, the other neighbor does what is proposed in this bill and has a quick sale and actually benefits from doing the writedown? I think that in many ways these negative equity certificates really do deal with the issue far more elegantly and, again, keep us out of dealing with it.

So the biggest issue—and it seems to me that Chairman Dodd's bill also builds upon the FHA to actually do this. Is that correct? I mean, it is within the FHA, a new organization, a new entity inside the FHA per this bill, per his bill would actually carry out the efforts proposed in this bill. Is that correct?

Mr. MONTGOMERY. As I understand, there is a board that is created that would set, you know, debt-to-income ratios, things of that nature. We would just submit, since time is of the essence here, that we have that existing——

Senator CORKER. So it seems to me also if this bill becomes law that there actually has to be an appropriations process to actually fund it. And it seems to me that everything that the bill lays out can be done within the FHA today. And it seems that the negative equity certificates are a much more elegant way of making sure we have no moral hazard.

In addition, I guess the whole issue of debt forgiveness creates income, does it not?

Mr. MONTGOMERY. Well, in our case, there would be some debt forgiveness. I think a lot of lenders and others are looking to see, to the Chairman's point, where the floor is. But, you know, once it is written down to an appraised value, we come in and insure 90 percent of that. That other equity is held as a soft second.

Senator CORKER. But since it is held as a soft second, the borrower, who already has financial issues, does not owe the IRS money; whereas, if there is debt forgiveness, my understanding is that is income. It always has been income in the past. Is that not an issue that would have to be dealt with?

Mr. MURTON. I believe that was taken care of in recent legislation.

Senator CORKER. For a short window of time.

Chairman DODD. It was taken care of.

Mr. POLAKOFF. Senator, I believe there is a 2-year window, I think, for debt forgiveness not being considered income to the borrower.

Senator CORKER. OK. And I would just say that it seems to me, then, on that note, though, that this is something that is set up to actually go forward, per the administration, for a longer period of time. We are only about a third of the way through resets at this moment in time. Is that correct? We still have tremendous num-

bers of resets to be dealt with. So it seems to me that the issue is urgent, that the FHA is set up at this point to deal with it, that it, in fact, takes no appropriations process for this to occur. And I guess the big question comes back to a question Senator Menendez offered in his opening statements. But is the FHA set up to plunge into this and deal with this plan in a way that would alleviate the need for any legislation of the type that is being discussed today?

Mr. MONTGOMERY. The only difference being that we have a 2.25-percent premium cap right now to expand the fence line out a little further. We would need some flexibility in that premium structure since we are a self-sustaining entity that does not take taxpayer funds. Again, we are coming at it from a delinquency standpoint, things of that nature.

So, yes, we are doing a lot of this now. We think in the interest of time the best thing is to let the Federal Housing Administration, perhaps with some legislative fixes, move forward.

Senator CORKER. And could you be very specific about what those legislative fixes would need to be to cause us to move forward immediately in a way that appears to me to really be at no taxpayer expense?

Mr. MONTGOMERY. Well, on the risk-based pricing, we have this guiding principle that we do not want to raise premiums on some family in Alabama or Texas who today is saving their money to buy a home in October, that we do not want to pay for this by raising their premiums and we want to wall them off from this. The only way that we can do that is to have some flexible pricing in that premium, recognizing the differences between the highest and lowest premiums. You know, our average borrower has a $50,000 income, buys $140,000 home. Those are very subtle dollar amounts, but they help our actuarial soundness, because we do not want to be back here later this year going to the appropriators saying we need money to keep our doors open, which I know seems almost counterintuitive because right now us and the GSEs are about the only game in town, so to speak. Our volume is up significantly. But, you know, we continue to have a drag on us with these seller-funded gift downpayments, and I cannot overstate that enough. And, again, this body has been great to address that.

Chairman DODD. Bob, can I just add, you know—here is what I am thinking. We have asked, by the way, CBO to score this, because obviously that is an important issue. And we do not know, but we believe that between the annual and the up-front premiums that we are talking about and the shared equity component that you have addressed here, we believe there is a real possibility that in terms of exposure, it would be minimal, and the tax provisions we think we have—the idea is to have a short window on this. Partly the idea of not setting up a whole new operation is exactly the point you are making. To go through that would be—we have an organization that knows how to do this in a way, and we are giving it a window of time. And you are right, we have resets coming. But if we can limit this in time and sunset this whole thing so you are in that window we are talking about on tax and we can avoid some of the very issues. I just offer that as a thought. But we are asking CBO to score it.

Senator CORKER. Well, you are addressing the specific legislative issues. You addressed one, and I think—I know my time is up, and I know we are probably going to have another round. But I will defer to Senator Menendez and come back and follow back up.

Chairman DODD. Bob.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, a lot of questions have been raised here, and I appreciate the definitions of where there is common ground on the legislation and where there might be some differences. But I think some overarching questions were raised that we need to deal with as well, so let me go to the very beginning of your opening statement.

You said, "Yesterday, Americans paid their taxes. That payment is a responsible action by each citizen, a necessary duty to pay for the services provided by the Government. Our citizens expect us to spend that money wisely, carefully, judiciously. After all, it is their money. They don't want us to use tax dollars to reward risky behavior or irresponsible lending or to create moral hazard. We all have a duty to be good fiscal stewards." And I cannot think of anyone on the Committee who would disagree with you. But that should be across a spectrum, should it not?

Mr. MONTGOMERY. Absolutely.

Senator MENENDEZ. So when we gave $29 billion to JPMorgan to buy Bear Stearns, did we create a moral hazard?

Mr. MONTGOMERY. Sir, that is a little out of my lane. I am the Federal Housing Commissioner.

Senator MENENDEZ. I understand that, but I think you have some sense of it. I mean, we had the Chairman of the Federal Reserve here, and I asked him questions about, well, what is the liability to American taxpayers, couldn't define it for the Committee. Twenty-nine billion dollars in record time.

Now, what message does that send to Wall Street about responsible behavior? See, if we are going to have a standard, which I think is an exemplary standard, then it has to be a standard across the spectrum. It is very hard for American homeowners—and, you know, I understand—Senator Shelby, whom I have a great deal of respect for, raised a question. Who is a victim? Who is an accomplice?

Well, let me ask you, gentlemen: In a score of 1 to 100, with 100 being the best score, what would you say is the average American's financial literacy score? Anyone want to venture to give us a sense of it?

Mr. MONTGOMERY. I would—rather than giving you an exact score, I would say probably not very high, sadly.

Senator MENENDEZ. Would you all agree that would be the case?

Mr. MURTON. I would agree.

Mr. POLAKOFF. Yes, sir, I would agree.

Senator MENENDEZ. And that is one of our great challenges, because the reality is, having practiced real estate law for a fair amount of time before I came to the Congress, I have to tell you that I had many hard-working people who I had to go to great pains to describe what their mortgage commitment was and what they were getting into, because they had absolutely no sense what-

soever. And the reality is that they were trying to reach for their dream, and they were trying to do it responsibly.

And what I am saying here is, you know, the financial literacy is something I hope the Committee will increasingly pursue, Mr. Chairman, something I know I am personally interested in and have some initiatives on. The reality is this is a critical component because at the end of the day, whether someone is a victim or an accomplice, you know, depends upon in part what is their financial literacy. And I would venture to say that a great number of people—I have read from my own case files, individuals, including people who had standard mortgages for a long period of time, and, in fact, were good credit scores and had been responsible payers, and then were lured because they were told, "You are paying too much on your fixed-rate mortgage. You can actually get this lower rate," and were told a whole series of things that led them to believe, they thought responsibly that, in fact, making that move made sense, and now they find themselves retired with their income stream fixed, and in the process of losing a home they otherwise would have kept just by continuing to pay their conventional rate mortgage. And I have got a whole bunch of stories like that.

So moral hazard, you know, I have a problem with $29 billion to JPMorgan for Bear Stearns where the Chairman of the Federal Reserve cannot tell me what American taxpayers who paid their taxes yesterday liability is, and yet we can say to our millions of homeowners in this country that are going to affect our economy, all of our economy, that we think that 3 percent in the latest report from the Center for Responsible Lending still has that the industry plan reaches only 3 percent of at-risk homes. That means a 97-percent correction rate. Are we willing to take a 97-percent correction rate in the marketplace, not just for those millions of Americans who will lose their homes but the consequence to the rest of us? That is the essence here, Mr. Chairman, of how we look at the issue. And I think it is very important how we look at the issue.

You know, why did we go ahead and do that for Bear Stearns—or for JPMorgan to purchase Bear Stearns? Because there was a general consensus that there is a consequence to the broader economy if we did not, right? Isn't that basically what was the argument? Well, there is a consequence to the economy of what happens if we do not do something significant about these mortgages?

So where is the difference between the moral dilemma, the duty to be good stewards, and rewarding risky behavior? And, by the way, where are the regulators who have the power to stop or intercede in a whole host of these instruments that, in fact, would not have brought us to the point we are? Where is their responsibility? Where is the risky behavior, good fiscal stewards standard for them?

So as we apply these standards that we want to say this about homeowners whose, admittedly, financial literacy rate is on the lower side, and say we go to rescue Bear Stearns, and we say to the regulators, oh, well, we are the clean-up brigade versus the preventers of what is happening, let's apply that across the spectrum, and then I think it will be fair. But if we are only going to apply that to the spectrum of those people who made decisions that largely are victims, I have a real problem with that.

Last, Mr. Chairman, I just want to ask one substantive question in addition to making—because I think the broader statement, if we are going to move forward on this, we have to have the parameters of what is, you know, good for the goose is good for the gander, so to speak here, and knowing what the standards are that we are going to apply across the board.

But I want to ask you, Mr. Montgomery, I have heard reports that the FHA is no longer accepting borrowers without a credit score. Is that the case?

Mr. MONTGOMERY. Well, FHA is about the only entity that does not base a decision solely on the credit score. That has been one of the hallmarks of FHA for generations.

Senator MENENDEZ. Is that still your standard?

Mr. MONTGOMERY. Yes, that still is.

Senator MENENDEZ. So you are accepting individuals who do not necessary have a credit score?

Mr. MONTGOMERY. Yes. They are a very, very small portion of our portfolio, less than 1 percent, probably.

Senator MENENDEZ. Because there is a fair number of borrowers who do not have a credit score, but who use payment history such as rent, utilities, and other bills that are well documented or solid, responsible payers that, in fact, can hit a 620 score, FICO score, and are well within the FHA parameters. Those people are not being eliminated at this point?

Mr. MONTGOMERY. No, sir. As a matter of fact, we support the provision in the Senate bill that would—assuming it is still in there on a pilot program going forward for non-traditional——

Senator MENENDEZ. Is the secondary market changing their standards in that respect?

Mr. MONTGOMERY. Well, a lot of the pricing from private mortgage insurance companies, certainly from Fannie and Freddie, we are seeing a lot of cutoff points on FICO scores, absolutely, and certainly a repricing if not a retreat from the higher LTV/lower FICO score market.

Senator MENENDEZ. Well, we look to see what exactly is happening there. You know, 22 percent of Latinos in this country have no credit score whatsoever. But yet they, in fact, have some great records of establishing due payments on time, long periods of time that would give them access to an opportunity to be considered. If we start eliminating that without looking at the substance of their abilities to pay, we are going to deny a whole host of people in the rush to now respond to some of what has happened before.

So we have to be, you know, cautious, but at the same time we do not want to just eliminate opportunities for people across the spectrum who otherwise can be responsible lenders and good payees.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Reed.

Senator REED. Well, thank you, Mr. Chairman. And thank you, gentlemen.

Mr. Montgomery, all these different proposals anticipate an expanded role for the FHA and raise several issues, but two major

categories: first, financial capacity and, second, managerial capacity.

With respect to financial capacity, it was reported recently that for the first time in the 74-year history of FHA, you might be running a deficit with respect to your portfolio. Can you comment on that, how it would affect you going forward or what steps you are taking to reverse that troubling trend?

Mr. MONTGOMERY. And I have commented extensively on this and met with a good bit of the staff that is sitting behind you who have been very supportive in this. That is the irony here, as FHA's volume continues to grow, that we continue to have a drag on our solvency because of the proliferation of seller-funded downpayment assistance. Six, 7 years ago, it was barely 5, 7 percent of our portfolio. It is as high as 33 percent overall, and in some States—Texas—it is about 45 percent of our FHA portfolio.

The IRS has put these organizations on notice that circular financial arrangements, things of that nature, it is clearly an inducement by all parties that you do not see in any other 501(c)(3). We could be the largest mortgage insurance entity in the world, but as long as we have that large a percentage of loans that use that sort of assistance—we are the only customer, by the way—then we will continue to have the drag on our financial solvency. And I have been sounding those alarms now for some time.

Senator REED. Now, let us talk about managerial capacity, which is the resources, and many times, I suspect, you know, in comparison to a major mortgage lender and insurance company, your software, your hardware, your employee base is not as robust as you would like it to be, I suspect. Can you comment on that also?

Mr. MONTGOMERY. You are absolutely correct, Senator. I mean, we have made some improvements to our existing systems—the average age of which, by the way, is about 18 years. And we can handle it. But I will say going forward we need a long-term fix to our information technology.

The good thing about HUD is we have a very, very experienced and hard-working, dedicated career staff. But they have been there many, many years, and a lot of them are retiring. Just this year, I have to hire 400 people. That is just to keep even to where I was last year. And it is a problem we have been trying to address.

The good news is—I guess the bad news is while there have been a lot of layoffs in this industry, we are getting a lot of high-quality candidates.

Senator REED. Right. I mean, one of the unfortunate consequences of the economic climate and the meltdown of several major mortgage entities is that there are very talented people out there, unfortunately, that might be available. But I think this goes to part of the effort of reform to reauthorize FHA is that there has to be, I think, both the authorization of resources to modernize your information systems, to make sure you have appropriate staff, and also, I think, going back to the point about the seller-financed downpayments, did you have any discretion with respect to those products? Can you limit it within your portfolio? Or the other question would be it grew from 5 percent to 35 percent. Just in the general portfolio of management, having an asset like that becomes so large so quickly it would raise questions. Can you comment?

Mr. MONTGOMERY. Well, it would certainly raise questions. Obviously, we are bound by the Administrative Procedures Act. That process, as you know, can be quite time-consuming. I will briefly summarize here. We have put out a proposed rule. It went out for public comment. We put out a rule that was going to basically eliminate that sort of assistance. We were sued. There are various movants and intervenors within those cases, and the judge—it is the Eastern District Court of California, the Federal District Court of Washington. Both ruled against us. They enjoined us from implementing the rule.

I will say this: If you read both of those decisions, I do not think the judges attacked us on the merits of the case, the evidence of the case, but they certainly hit us on the Administrative Procedures Act. And I will say this: They gave us a good road map to get it right.

Senator REED. OK.

Mr. MONTGOMERY. It was not good enough for us to be 97 percent right in their mind. We have to be 100 percent right. And we will continue to move forward.

Senator REED. Thank you. Just let me raise another general question or a comment for the panel. I was listening intently to Senator Tester, who I think made a very profound point about these types of arrangements where people could buy a home without any money down. I had to buy a home, too, and, you know, we put down money because one thing we wanted to do is avoid paying mortgage insurance. So we put 20 percent down, and, you know, fortunately, we had it. But the whole mortgage insurance market is not there to help out now for some of these defaults because of the second mortgages which are issued simultaneously.

It suggests to me that a lot of this was—the people who were writing not just the first mortgage, but also encouraging the borrower to take a second mortgage for a 100-percent financed house with zero down and also not looking carefully at the income capacity of the borrower, I mean, it goes back to the point the Chairman made. That seems to be mortgage malpractice, writ large. And, you know, one of the issues that struck me here is that, you know, a lot—in the old days, and I will date myself, if you—you know, you had to put the money down or you had to have mortgage insurance. If the mortgage went bad, you know, you lost the house, but the financial system recouped the mortgage.

Any comments in terms of this problem, or reactions? Mr. Murton or Mr. Polakoff.

Mr. MURTON. Well, perhaps it goes back to the point I think you made earlier, Senator, that people believed housing prices would always go up, and I think we got ourselves into that mind-set starting with the low interest rates, and then following that the unsustainable credit expansion.

Mr. POLAKOFF. Senator, I agree that there was much irresponsible lending by mortgage companies and mortgage brokers, and I do believe that there were some poor decisions made by some borrowers who should have known better and were taking advantage of the system as well.

Senator REED. I mean, one of the things pointed out to me is that, you know, if you have a stable income stream, getting a sec-

ond could be a financially shrewd move because you avoid the monthly mortgage fees and mortgage payments, et cetera. But in the case of so many of these borrowers, particularly the subprime, where they did not have those assets, did not have those income streams, and getting into a second and being—and having someone underwriting that mortgage, that first mortgage, knowing that there was no equity, was a serious, I think, lapse of judgment.

But, Mr. Chairman, again, thank you for this hearing. I have learned much. Thank you.

Chairman DODD. Thank you very much, Senator.

Just picking up on Senator Reed's point, I think, you know, what was the underlying thinking of people in all of this? And one is a sense of optimism. I mean, you could say that they should have had better judgment in some cases, but that sense of optimism and confidence about their country, about themselves, about their futures is a valuable and tangible asset in all of this. And why are people doing this? Why were they taking that second? And you go back and you realize what tremendous economic pressure people have been under.

I cite these statistics, and when I do, every time I say them I find myself questioning, and I go back and confirm them again. Between 2000 and 2006, if you exclude supervisory jobs in the country and speak only about 124 million Americans in non-supervisory jobs, their wages went up $1.60 in 6 years—$1.60. Not a year, not an hour. That was the total wage increase for 124 million people. That is $200 million in wage increases in that 6-year period of time. I might point out the five investment banks gave bonuses of $35 billion in that same 6-year period, by the way. And so when people have that limited income growth—and you are looking at energy, health, food, other matters going up—this idea of taking that second mortgage and doing—it was not out of greed. They are doing so because they are trying to stay afloat. That is why there are second family jobs, that third job, that fourth job. That is why credit cards in many cases people are financing these things. It is not just irresponsible behavior. It is people trying to keep their families together in very difficult economic times for a lot of them. And there are other things they probably should not be doing. I am not trying to create some image of a person who has been absolutely perfect, but the motivations here are not just about greed. They are about surviving in many cases. And they are about optimism, and it is about confidence about their futures.

I think before we just decry all of this, we ought to understand the framework and the understanding of what motivated people in those moments to do what they did, the idea of having a home, raising a family in a place you call your own. I am a provider. I take care of my family. My wife and my children would love to have their own house. And that has been a strong emotion in our country from the founding days of this republic. Today, we find ourselves at a lot of risk of all of this.

So just this idea of indicting people out there because they got themselves into bad deals, as we heard a minute ago, we have had people talking them into this stuff. I mean, I still go back—every time I look at that website of the brokers that the first rule is, hold yourself out as the financial advisor of the borrower. A complete

lie, because you are being paid based on yield spread premiums that reward you for how high a rate you can convince that borrower to take. And when you are looking across the table at someone who is a borrower who believes this person is their advisor, you know, there isn't exactly a level playing field in that sense, either.

Let me address, before I turn to Senator Corker, I know Senator Corker has some questions, Bob asked some very good questions. He asked about is there new legislation required here, and I asked my staff to kind of do a quick run-down here and let me share some thoughts we have on this and whether new legislation is needed.

HUD is claiming—and Brian, you are correct on this—that it will serve up to 500,000 people with the new expanded FHASecure program. At least that is the number I have been given. Is that right?

Mr. MONTGOMERY. Yes. With this expanded FHASecure, by the end of the calendar year——

Chairman DODD. Right. OK. And I think Senator Corker raised a very good point earlier, and I appreciate it, as well. I mean, I don't know how we are going to do with this bill. I am going to try and move this idea. But I know in the process, we are also moving people probably to do some things they weren't going to do in the absence of suggesting some ideas here, as well. So to some extent, I guess I ought to be taking a degree of satisfaction in that people are moving in a direction that I am not sure they would have been moving in had we not been proposing some of these ideas.

But the administration was very slow to acknowledge the mortgage problem, as I mentioned at the outset of my remarks, and I say this respectfully, but there was just a failure going back more than a year ago. I might add, by the way, when I took over the Chairmanship of this committee a year and 2 months ago and my staff met with Federal Reserve Board staff, stunningly, they told us, the staff, they were aware of this problem emerging at that point, three-and-a-half years earlier.

And so when we talk about this problem popping up last year, in fact, knowledgeable people claim they were beginning to get concerned about this issue, broadly, some time before then, and I just share that with you this morning.

Congressman Frank and I have been talking about a larger scale and a more aggressive government program to assist home owners since late January, and last week, April 9, the administration announced its plan to expand FHASecure. We welcome that. I am just pointing out, this was a year and a month after we have been raising the issue. It is good to get it, but if you won't mind me saying, I wish we had had a little earlier reaction to all of this. And in short, by pushing the Hope for Home Owners Act, I think we have been helping the administration move in the right direction.

The Dodd bill expands the universe of eligible borrowers beyond the recent expansion of FHASecure. It gives the authority to FHA to raise fees beyond the current level, which I think is a benefit. I appreciate your point, Brian, that the levels are where they are, but we think by going a little higher, we actually address some of the underlying questions about taxpayer exposure and the like and making sure that borrower is going to have some skin in this so that they are going to get covered, as well. So giving HUD the au-

thority to charge more will allow it to expand the universe of eligible borrowers.

In our discussions with servicers and lenders, there is a strong sense that our program could be effective even for borrowers who are more than 90 days delinquent. The HUD program would not extend to those borrowers, which is a limitation. I don't know if that requires new legislation or not, but that is one of the things we are talking about.

Third, the legislation also creates a safe harbor for servicers so they will be more willing to participate. That requires legislation because that doesn't exist.

And fourth, our plan creates a board, as you have been pointing out and talking about, that doesn't exist, obviously, that includes Treasury, FDIC, as well as HUD, and we provide for lending of staff from other Federal agencies to help implement the program, one of the things we don't do enough around here, because while this isn't the only universe to deal with, we understand there are others that can come into this process that could be helpful and we do that. I don't know whether you need to do that by regulation or legislatively, but it is one of the things we include legislatively to try and cover some of those questions that I think you properly raise. Do we need more authority under law to allow us to do some of the things we are doing?

I have a lot of faith in FHA to be able to do this. I think you run a great shop. I think you make a huge difference for people. I think the modernization effort is going to be a major step in the right direction. And I don't think you have to go out and recreate some agency to do this. I have a lot of confidence you and the wonderful staff you have can handle this idea, and as long as CBO gives us a mark here we can work with, then we may not even need to go through an appropriation process.

So the last thing I want to do is go out and start some whole new ballgame here in town that you never get rid of. The old axiom in Washington was, you create something new, it never goes away. And the last thing we want to do is create something new that won't go away. So just to address a couple of those questions.

With that, let me turn to Senator Corker.

Senator CORKER. Well, thank you for those comments. I think they are very helpful, and actually, I was confused, I guess, at the end of my last questioning as to what did need to happen to allow FHA to do what it has proposed through this Secure program. My understanding is if we were to pass the FHA Modernization Act, that that covers all the things that need to occur to handle the portions that you have described, not the additional portions Senator Dodd has described, is that correct?

Mr. MONTGOMERY. That is correct. But to go above the premium structure, we would need—to do risk-based pricing, we would need some——

Senator CORKER. But we already have legislation that moved a little ways and is now bogged down. But, in fact, if FHA modernization passes, you have the frames you need to continue on with this aggressive effort you have laid out?

Mr. MONTGOMERY. By and large, yes.

Senator CORKER. OK. So just to gain again more common ground, I would like for you to address what our Chairman has laid out regarding expanding the program in the means that he has talked about and then give a little bit of an explanation regarding this safe harbor component that he also has laid out in his legislation.

Mr. MONTGOMERY. I will just say that the safe harbor, we can expand more on in writing. It is a little out of my area and more to the gentleman to my left.

Again, going forward, I would just say, I think in concept we agree. A lot of families are in the right house with the wrong mortgage. There are some issues of predatory lending, too, where there is no doubt a lot of people were steered toward higher-cost loans. But trying to thread the needle, there are some very good things in the Frank proposal, there are some very good things in this proposal. I say personally there are some very good things in our proposal. But just going forward with the things the gentleman to my left had mentioned, there are a lot of players. There are a lot of legs on the stool and how can we make sure, whether it is a piggyback loan that the Senator over here discussed, there are a lot of players here that can bollix the whole thing up, so to speak.

So going forward, we think doing the 90 percent LTV is good with a subordinate lien, but it will do us no good if whoever is holding the second on that piggy-back loan right now doesn't want to go forward with it. And so that is why I think extinguishing those loans with a mandatory write-down, I think may limit the ability of this program to go forward.

Senator CORKER. But that issue exists under the Dodd proposal and your proposal, is that correct?

Mr. MONTGOMERY. Well, in ours, we would allow—certainly people could do write-offs today, by the way. I think the point was made earlier, a lot of people are waiting to see where the floor is. There is no mystery there are a lot of proposals floating out there. But in our proposal, FHA would only insure 90 percent of whatever the appraised value is, so that 10 percent equity would be in the soft second with a note, due-on-sale clause, something of that nature. Now, certainly the lender could put all that in a soft second. Eventually, home prices will go up. Again, I would just say we are trying to get to the same thing here but just a little differently.

I would also say I think we need some rigid debt-to-income ratios for underwriting. We don't want FHA to throw the baby out with the bath water here. We need, I think, to insert some fairly rigid debt-to-income ratios in there, as well.

Chairman DODD. Can I bump just on this, because this piggyback loan issue, and I should have mentioned this earlier, sort of make this more free-wheeling, is we required in the legislation that that second lien be extinguished. That requires a negotiation between the first lien holder and the second to work that out, because it is not going to happen if it doesn't. So there is no fancy I know of how to deal with this other than require that before you can participate in the program, if you want to, you have got to negotiate that out, and——

Senator CORKER. But that is on a voluntary basis.

Chairman DODD. That is a voluntary basis, yes. Otherwise, it can't work, obviously. You have got a huge problem there. So the law says, in effect, resolve that before you step up. Now, I realize there may be those who can't, so that is going to strike out a certain number. But otherwise, it wouldn't work. I don't know how you resolve the problem otherwise.

Senator CORKER. Since we are in this free-wheeling mode, the negative equity certificate notion does seem to do away with the issue of moral hazard. In other words, the debt is still there. It has no interest that is being borne on that debt. But at any time in the future should the home sell, that debt is repaid and so you do away with the moral hazard issue. I would just be curious what your response to that is——

Chairman DODD. I welcome that idea. I think that idea has value. That is the carrot. I have got to get that investor to come up to the plate here. Obviously, the borrower wants to be here, although he is going to pay insurance, he is going to have to share back. The question is, can I get those piggy-back loans worked out. That is no small hurdle to get over, but let us assume he can do that.

And then I have got to get that investor to do what culturally they have never been inclined to do. It is almost a cultural problem, in my view, and that is culturally, experience has told you in the past, get him out of the house. We do better under those circumstances than fooling around with a delinquent mortgage holder, or payer, rather, in this case he is. So there has got to be an incentive for that person to come forward.

So I find that idea very appealing as a way of drawing in, for less of a moral hazard reason than I am—if I don't get people to participate, this is just a lot of paper——

Senator CORKER. But it is also more streamlined in that you basically keep the arrangement between the lenders and the home owner instead of having a third party that is benefiting somehow from the sale or the value down the road and then figuring out who made it worth more. Was it things the homeowner did? It seems like to me, it is just a more elegant way of dealing with that particular cumbersome sort of problem there.

Chairman DODD. And I want to, again, I don't want to overstate a case to you in how you work that out, but I like the idea because some of that is involved. I will leave it there.

Mr. MONTGOMERY. I would just say, we allow that under FHASecure, depending on whether they want to do a write-off, because they know they will certainly take a larger hit if it goes to foreclosure. But again, you couldn't put it on the part of the soft second because the prices will go up and you will make some of this moral hazard that they had this windfall, so to speak.

Senator CORKER. So I will summarize. I know Senator Carper is here, too. But it seems to me that actually, there is tremendous agreement here. In essence, it is a voluntary program.

Chairman DODD. Right.

Senator CORKER. It is one that the lenders participate in with their own desire. They have to work out things with the second and third or fourth and fifth mortgage holders, as they may be. They have to work it out with them.

Chairman DODD. Right.

Senator CORKER. What is——

Chairman DODD. Owner-occupied.

Senator CORKER. Owner-occupied. The fact is that it gets the person in the home in a position, again, on a voluntary basis by the lender, that allows them to actually make mortgage payments, OK——

Chairman DODD. They can afford.

Senator CORKER. Ones that they can afford. There is no moral hazard if, in fact, we adopt this principle because there is a negative equity certificate, so the value of the home has to come back up at least to where the indebtedness was before there is any profit made by the home owner. And it just seems to me there is a lot of mutuality that we somehow ought to figure out a way to do, hopefully without legislation. I know you are talking to your staff. This is the part I wanted you to hear. Hopefully, without legislation. But it sounds like there may be some tweaking someplace.

I would love for you all, if you would, at least to our staff and hopefully everyone, get back with us on the two issues, I guess, that Senator Dodd has brought up that I am not sure that I still fully understand how we would deal with the expansion piece and the safe harbor piece. But it seems to me we have had 2 days of streamlined surgical-type approaches to problems that really affect people.

Chairman DODD. The bill hasn't changed in the last month.

Senator CORKER. Well, I think the issue of sharing—I think that sharing issue is a major, major—I think that is a major issue, and I think bringing in a third party to be involved in that is just something that is very troubling and very cumbersome, just for what it is worth. But I think that laying that marker out has caused other people to think about it in a different way and I think all these things are good.

Chairman DODD. Thank you very much.

Senator Carper.

Senator CARPER. Thank you. On the issue of the negative equity contract, or negative equity certificate, when I first heard about it, I thought that this sounds like an elegant solution. In fact, those were my words, too.

Let me just ask. Is there some precedent in the last decade or two where something like a negative equity certificate was used in another day and another way, maybe with the S&L crisis? Is there a precedent for that so we can actually look back and see how it was used and if it was to good effect or not? For some reason, in the back of my mind, I am thinking that there may have been a precedent for this that we can learn from.

Mr. MURTON. Well, it may not be an exact analogy, but certainly the FDIC and the RTC when they resolved failed institutions and had to pay off the insured depositors and took assets and we had people work those assets, we had arrangements where on day one you didn't know the value of it, but if it turned out that the properties we realized more value from, or the person working it for us realized higher value, we shared in that. So we have worked out a number of different sharing arrangements when values are uncertain and they worked quite well for us, I would say.

Senator CARPER. OK.

Chairman DODD. I might say, Tom, on the Bear Stearns-J.P. Morgan Chase, I wish we had had some warrants coming back. We did that with Chrysler.

Senator CARPER. We did that with Chrysler.

Chairman DODD. We didn't get anything out of that thing. You talk about these certificates coming back, the people putting a lot of skin in the game are the very people we are worried about here right now. We have got virtually nothing coming back on it except the hope. So I believe it will work out, but very little protection.

Senator CARPER. Yes. Mr. Polakoff.

Mr. POLAKOFF. Senator, if I could dive down to the weeds for a moment without boring you——

Senator CARPER. Go ahead. We will try to go with you.

Mr. POLAKOFF. The concept from an OTS perspective allows the servicer in the securitization to literally write down the amount of the loan to the negative equity aspect of it, subordinated to the first, which would be an FHA-guaranteed first. So while the term negative equity certificate has gained a lot of traction, really what we are talking about is writing down the principal to that amount and then subordinating it to the first, making it non-interest bearing, changing the terms so that the maturity would either align with the current terms of the note or when the borrower sold the home.

Senator CARPER. All right. I think I understood most of that. Thank you. An elegant explanation.

I had an interesting conversation. The Chairman and I and some of our colleagues were able to discuss issues of the economy, some of the housing issues that were before us this past weekend. One of the folks who was there with us was the former, I think, Chief of President Clinton's Council of Economic Advisors, Laura Tyson, and we talked a little bit about the issue of how do we—the sharing, if you will, after a second mortgage note, after a mortgage is reworked and you have a foreclosure avoided and then you have an appreciation over a period of time, to what extent does the borrower share in that and to what extent would FHA. If FHA is involved, to what extent would they share in it.

I think Chairman Frank has a proposal that would say the first year, FHA, I think, would get 100 percent of the uptake, and that would be phased out over 5 years until FHA would get zero. I think I am on the right track here. I believe in Chairman Dodd's mark that it is a little different take. Say the first year, FHA would get maybe 100 percent, 90 percent the second year, and then down to 50 percent, and for an indefinite period of time beyond that, it would be split 50–50 between the borrower and FHA. There are a variety of different proposals.

Ms. Tyson suggested to me—I guess it is Dr. Tyson suggested that maybe a better approach, she said, you need more than 5 years, and she was talking to Chairman Frank's idea. She said, you need more than 5 years, maybe 10 years. So the first year would be 100 percent FHA and then down and by the tenth year be 10 percent FHA and then the home owner would realize the entire amount.

But there are different ideas here. Which of these approaches makes most sense to our panelists?

Mr. POLAKOFF. Well, I would offer that what makes most sense is for the servicer in the securitization who is taking the write-down, and in this case taking a write-down beyond the current fair market value to 87 percent of the fair market value, deserves the upside potential of a negative equity certificate to be shared with the borrower. The borrower needs to have an incentive to stay in the house, improve the house, look to eventually, if he or she wishes, sell the house, and I think we should at least discuss the benefits of some sort of interest for the second lien holder to once again be willing to subordinate their position.

Chairman DODD. That is a very good point, by the way, and one that Ben Bernanke has made, as well, in talking about that.

Senator CARPER. OK. Good. Mr. Murton.

Mr. MURTON. I think I agree that the negative equity certificates help address some of the moral hazard problem, and then I think the question is who do you share it with, the FHA or the investor, and I think there are arguments on both sides and maybe you can work out some arrangement where if the government is taken care of, maybe then it goes to the investor. There are lots of ways to structure things like that.

On the issue of 5 years versus 10 years, perhaps Dr. Tyson was thinking that in the past, it has taken quite a while for home values to recover and the longer horizon may add value to that and that is a legitimate point.

Senator CARPER. OK, thanks. Mr. Montgomery, a quick comment?

Mr. MONTGOMERY. Just real quickly. There is not a lot of difference between the negative equity certificate and what we are proposing and rolled out last week with FHASecure, just we would put it in the form of a second subordinate lien. I just want to make that valid point.

Also, I do want to say that on principal, we weren't a party, FHA wasn't a party to the original transaction. I am not so sure we should be sharing in equity, so to speak. If a borrower today buys a home with FHA insurance and 10 years from now they have a profit from it, we don't come back saying, hey, we need a cut of that. That is why they pay premiums, up-front premiums and annual premiums. I think we can accomplish the same thing.

I think we all agree, yes, owner-occupied homes. We want to keep that borrower in the home so they will realize some profit. We just would maybe do a re-sell restriction, due on-sale clause, something of that nature.

Senator CARPER. All right. Just a closing thought on this, Mr. Chairman. I am looking here at this glass of water. Some people would look at this glass of water and say it is half-empty. I think in terms of actually finding common ground and moving legislation, the glass is half-full and I think we have an obligation to work very hard to find the middle ground in some of these areas. To the extent that some legislation is needed to complement what FHA is doing on their own and others, so be it. But I am encouraged.

Chairman DODD. Senator Corker.

Senator CORKER. Unless you need to go to lunch or something, I will ask one more question. When I was mentioning third party earlier, I really meant FHA playing a role in equity sharing, which I think was just addressed. I don't think that is an appropriate thing, but yet maybe having the interest payments due to the second mortgage holders at some point down in the future, maybe that does make sense, and I think we all nod our head in that regard.

Getting back, though, to the debt forgiveness issue that I brought up earlier, and I realize our first stimulus package addressed that for a period of time, whether it is a second mortgage, as was just laid out by Mr. Montgomery, or whether it is a negative equity certificate, those do address the loan forgiveness issues in different ways. I assume if it was second mortgage, as you have laid out, there is no debt forgiveness, and so that is not triggered. If it is a negative equity certificate, I guess there would be a question, is that like a financial instrument that is a lien and is there still debt or not?

But I think that while we are all here and while you all are all here, since something may happen soon, it would be interesting again just to sort of revisit the issue of debt forgiveness and how that ought to be addressed and I would love to hear from all three of you.

Mr. POLAKOFF. Senator, I would say that under the negative equity certificate, if the borrower sells the home for an amount less than the negative equity certificate, then there could very well be—there would be a portion of debt forgiveness associated with that, yes, sir.

Senator CORKER. And that would occur, like, way down the road?

Mr. POLAKOFF. Potentially, but——

Senator CORKER. And I am just wondering if that is something we actually addressed appropriately, if you will, in the first economic stimulus package. But that is something that could happen 8 years from now, is that correct?

Mr. POLAKOFF. Yes, sir, though one would hope in 8 years there is much home appreciation.

Senator CORKER. Do you want to address that, Mr. Montgomery? I mean, there are two different approaches. It seems that yours, you never forgive the debt, is that correct?

Mr. MONTGOMERY. Well, whoever the existing servicer and lender is, I mean, there may be a charge-off going on. The home is worth—there is a $120,000 mortgage and the home is only worth $100,000. We insure 90 percent of it. They could put that delta, all of it in the form of a soft second, recognizing that prices ultimately go back up. They may decide going forward with an agreement there is a charge-off of $20,000 of that $120,000 and there is just 10 percent in——

Senator CORKER. And again, that is a voluntary decision——

Mr. MONTGOMERY. Yes, absolutely. So there are a lot of ways to come at it. I mean, there are circumstances that will be unique for a lot of borrowers. They will be unique regionally. I think getting all the players involved to agree that they may ultimately—the current lien holders get something out of this, maybe the second lien holder is five cents on the dollar, I think is probably all they are

looking for, 10 percent, maybe more. But we think going at it a little differently, I think we seem to be moving in the right direction.

Senator CORKER. Thank you very much.

Chairman DODD. And that point, as well. I appreciate Senator Carper raising the issue earlier. Again, obviously getting the investor, but also you want that borrower to feel not only they are getting their home, but that this is also—that home represents a secure economic future, as well. And so that incentive—and there will be those who may turn around and say, look, you are far better if I just walk away from this whole thing. So we want to make sure that we are incentivizing that in ways that keeps both parties to the conclusion that it is in your neighbor's interest and your interest and there is a financial reward for taking on this responsibility, and also from the investor side.

So striking that balance is probably never going to be absolutely perfect, but you try to keep that in mind, as well, as we go forward.

This has been very productive and very helpful, and great witnesses. I appreciate it very much.

We are going to try and move at some point here, I just say, on this. There is a sense of urgency about all of this. And again, Senator Shelby had to move on to another hearing he had to go to, and I appreciate his opening statement and talking about the very legitimate questions which this committee is raising at every aspect we can while simultaneously trying to come up with some answers. So we are going to continue to explore what happened. We have got some legislation dealing with the practices that got us to this point which have to be addressed. But if I had to prioritize what our agenda ought to be, it is trying to step up and doing something that hits the target and how do we short-circuit this problem from getting worse. Obviously, it is important to make sure we shut the door so it doesn't ever happen again, but if you had to choose which of those two is deserving more of this committee's time and attention, it is the first one. It is dealing with the problem, and so we are going to try and deal with that, also as well as focus on the other questions of how we got into this mess and what steps we ought to be taking to make sure we don't repeat it.

I thank everyone very much. The committee stands adjourned.

[Whereupon, at 12:18 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

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 Banking, Housing, and Urban Affairs
United States Senate

"Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets"

April 16, 2008

Introduction

Thank you, Chairman Dodd. I would like to thank you and Ranking Member Shelby for inviting me to testify.

Mr. Chairman, yesterday Americans paid their taxes. That payment is a responsible action by each citizen, a necessary duty to pay for the services provided by the government. Our citizens expect us to spend that money wisely, carefully and judiciously. After all, it is their money. They don't want us to use tax dollars to reward risky behavior, or irresponsible lending, or to create moral hazard. We all have a duty to be good fiscal stewards.

So, in the current housing crisis, I think we have to draw a line. Some homeowners used poor judgment. A lot of lending companies want a bailout. Some are using this crisis to advance ancient demands for more federal money, hoping to leverage this crisis into an opportunity.

Mr. Chairman, this is the time for clear vision. I am confident that we can find common ground to address the housing crisis, given our mutual interest in breaking the cycle of foreclosures. I know that we all want to find a way for FHA to help hundreds of thousands of Americans keep their homes and avoid foreclosure.

We must help responsible families and communities in need, without transferring risks and costs that should be borne by the private sector to the taxpayer. I believe most Americans want to protect homeowners who played by the rules. They don't want to have to pay for the risky financial behavior of others. 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. The taxpayers do not want us to federalize the housing market, which would be a terrible decision. 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. As the *Economist* and other publications have noted, some of the solutions under discussion could do tremendous harm, with little actual benefit to homeowners.

Mr. Chairman, 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 HOPE NOW Alliance, which together have helped more than 1.3 million struggling homeowners.

For the past 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. The Administration continues to urge Congress to reach agreement on a bill to modernize FHA that the President can sign it into law.

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. 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 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.

Mr. Chairman, 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 155,000 homeowners in need, and our projections show that we will likely reach more than 500,000 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. 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.

FHASecure

Mr. Chairman, FHA has been able to use our administrative authority to help hundreds of thousands of Americans refinance their home loans. In August 2007, President Bush introduced an effort, *FHASecure*, to help more Americans facing foreclosure refinance into a safer, more secure FHA loan. Since then, more than 155,000 families have been able to refinance with FHA.

We have always said we are open to further expansion, but done in a responsible way. Thus, last week at a hearing before the House Financial Services Committee, I announced some further administrative steps that will extend FHA opportunities to more homeowners that will help break the cycle of foreclosures. These efforts, using current regulatory authority, are targeted to distressed homeowners struggling to make their current mortgage payments and have no place to turn to refinance their loans as their homes lose value.

By tapping into its existing authority, *FHASecure* will now serve borrowers in subprime ARMs who have gone in to default as the result of some extenuating financial circumstance that has temporarily hindered their ability to afford their existing mortgage payments. These borrowers would still have sufficient income to make payments on the new FHA mortgage, but are stretched or unable to meet the terms of their existing mortgage. The refinance will put them in a sounder financial position. Borrowers who meet FHA's other underwriting criteria but have missed two monthly mortgage payments, either consecutively or at two different times over the previous twelve months, will qualify for a standard 97 LTV loan. For borrowers who cannot meet these standards, FHA will permit up to three months of delinquency, again, which could be a consecutive 90-day late period or three 30-day late periods. But, FHA will limit the LTV ratio for these borrowers to 90 percent. The 10 percent equity cushion, along with the required premiums, will protect taxpayers against unnecessary risk. FHA will also use its existing authority to adjust insurance premiums to maintain the solvency of the FHA insurance fund.

Mr. Chairman, expanding *FHASecure* in this manner will offer lenders a refinancing alternative that makes voluntarily write-downs a viable option. Appropriately reducing the principal

amount owed on subprime mortgages helps both troubled borrowers and lenders. Borrowers would reduce their principal payments and get to keep their homes. Lenders avoid taking a more significant loss at foreclosure. Neighbors avoid vacant homes in their neighborhood, depressing their home values. And localities keep a viable tax base to fund community health, schools, and other valuable services.

FHA underwriting standards will minimize the risk to taxpayers while being able to help more families use *FHASecure* to keep their homes. Let me emphasize that last point. Borrowers must also show a reasonable credit history, show employment history, and have some personal equity in the deal, and fully document and verify their income. Borrowers will be required to pay upfront and annual premiums on their loans, which directly contribute to the soundness of FHA's insurance fund and protect taxpayers. Since more than 90 percent of FHA-backed loans are 30-year fixed rate mortgages, this gives us predictable, stable income.

I want to also stress this: all the changes to *FHASecure* we have implemented or are about to implement will help us reach about 500,000 homeowners in total by the end of this year. Of course, the President's stimulus package is also making a difference. By temporarily increasing FHA loan limits, we can back more mortgages in high-cost states and help homeowners hold on to their houses. The new loan limits were announced last month, and I have spoken with many people in the housing industry who believe that this action will assist many homeowners this year.

Comments on Congressional Proposals

Mr. Chairman, I will now comment on the specifics of the legislation that brings us here today. While we appreciate many of the ideas proposed, respectfully, there are some elements that would be a mistake.

First, mandatory write-off of all existing mortgage debt will severely limit participation by existing lienholders. Their only incentive to support the new FHA refinance transaction and accept a short pay-off on the existing lien is the opportunity to recover some amount in the future. The bill, by stating that the FHA mortgage will be accepted as payment in full on all existing mortgage debt, is particularly detrimental for subordinate lienholders, who would be highly unlikely to release liens under such terms, as opposed to today's practice of negotiating some amount of payoff. Further, the bill undermines the servicers' fiduciary obligation to the investors, as agreed to in the securities contract.

The mandatory loss, when combined with the new LTV cap does not represent fair policy. The bill requires that the new FHA mortgage be set no higher than 90 LTV, but goes on to say that a lower LTV is permissible, to ensure that the borrower has the capacity to repay or at a level commensurate with the discounted price for which it was purchased. The former policy would effectively result in large subsidies for households to stay in homes that are significantly beyond their means, even at reasonably written-down levels. This is unfair to other households, the bulk of who made prudent decisions about the cost of their homes, who would not receive such a large discount in the size of their mortgage. The latter would take away any profit to be made by private investors who are now beginning to purchase pools of non-performing loans at a discount

and refinance the borrowers into new loans. Any of these policies, when combined with the mandatory loss to the existing lienholder, results in a huge equity gain to the borrower.

Second, to counter this "windfall," the bill sets up an equity sharing arrangement with FHA. But FHA is not the party that took a loss on the previous loan, so there is no reason to share equity. The only incentive for existing lien holders was the opportunity to recover some of this equity or additional appreciation, or both.

Third, the bill creates new programs and procedures in areas where the existing framework could achieve the same goal. 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 borrowers. I would think that the temporary nature of the fund suggests that the existing fund structure is appropriate. Moreover, the revolving fund structure in the bill is inconsistent with the Federal Credit Reform Act and would unnecessarily complicate the administration and accounting of the new program. The same objectives can be met through the existing fund structure. FHA also does not need a new Board to set out all new requirements and procedures for a refinance program. Such a practice would be redundant with FHA's existing management and staff capacity, and is therefore unnecessary and inefficient.

Fourth, a waiver by FHA of prepayment penalties on previous loans is not within FHA's jurisdiction. Modification or nullification of contractual obligations between the borrower and holder of the existing mortgage would create risk of litigation under the Takings Clause and potentially subject the Federal government to compensation obligations under the Clause.

Fifth, the bill provisions regarding GSE goals, which create an expansion and division of authority, further complicate the ability of HUD to do its job. The bill creates a new three-way responsibility for setting a new goal to encourage GSEs to purchase and restructure distressed mortgages to owner-occupants at-risk for foreclosure. In other words, HUD will retain independent authority for establishing the three current housing goals, but will split the responsibility for setting the new goal with OFHEO and the Treasury Department. No rationale for this goal-sharing responsibility is provided. There is no precedent for it. The likely outcome will be inefficiency and delay.

Further, there are other problems with the goal process. Whether the goal level is a fixed number of mortgages, proportional or percentage based, there is no data source for determining the number of owner-occupant borrowers with distressed mortgages that could be helped in a given year. Uncertainty in the validity of the goal level would mean, among other things, that HUD could not enforce goal performance because HUD would not know if the goal level was feasible or infeasible, which is a condition of goal enforcement. Even if a goal number could be estimated, there is no way to determine the willingness of lienholders to offer mortgages for sale and restructuring when those sales would require accepting discounted principal balances. This fact complicates the process of sizing the goal.

We believe the same objectives could be achieved within the framework of HUD's existing housing goals and in a way that does not risk the safety and soundness of the GSEs. A minor

statutory revision would permit mortgage work-out activities to count towards the housing goals, and HUD could award bonus points for this activity. Alternatively, HUD could also award bonus points for GSE purchases of refinanced distressed mortgages that lenders would originate at reduced principal balances and make the results of these purchases public on an annual basis.

Finally, while it is not a component of this particular bill, I want to remind the Committee that this Administration strongly opposes any provisions which would provide billions in loans or grants to States and local governments – whether through CDBG or other programs – 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. 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. Furthermore, if done through CDBG, it would effectively double the program in size with no additional staff to ensure proper oversight.

Conclusion

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 DELIVERY

STATEMENT OF

ARTHUR J. MURTON
DIRECTOR
DIVISION OF INSURANCE AND RESEARCH
FEDERAL DEPOSIT INSURANCE CORPORATION

on

HOPE FOR HOMEOWNERS ACT OF 2008

before the

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
U.S. SENATE

April 16, 2008
10:00AM
538 Dirksen Senate Office Building

Chairman Dodd, Ranking Member Shelby 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 Dodd'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

[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 of a federal process to buttress the efforts of the states to better license and police mortgage originators. Chairman Dodd's proposed Home Ownership Preservation and Protection Act of 2007, S. 2452, includes provisions that would bolster underwriting practices by specifying the duties originators and brokers owe to the borrower. 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, their best elements could be merged into a single proposal that would address this urgent issue and command widespread support.

We 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 the HOPE for Homeowners Act of 2008 (HOPE Act) is the creation of a 13 percent cushion against *current* appraised value for loans to qualify under this 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 affordable and 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.

HOPE for Homeowners Act of 2008

The draft HOPE Act would provide a voluntary mechanism to refinance troubled loans into long-term, sustainable loans. Overall, the HOPE Act 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.

As a prerequisite to entering the program, the HOPE Act 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 87 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 HOPE Act also would require that the new insured loans be properly underwritten and not exceed the reasonable ability of the borrower to repay. These requirements would help to ensure that the new loan is sustainable over the life of the loan. The new debt service payments would bear a fixed rate of interest and have a maturity of at least 30 years. Reasonable and prudent standards for operating the program and instituting underwriting criteria would be developed by an Oversight Board.

Under the HOPE Act, only owner-occupied residential mortgage loans originated on or before January 1, 2008 would be eligible for consideration. The lack of a definition of affordability, unless resolved by the Oversight Board, could significantly slow the process of restructuring loans as each loan is assessed for affordability. Establishing clear qualification standards for participation in the program based on standard metrics, such as debt-to-income ratios, would establish affordability on a systematic basis and ensure the program is targeted to borrowers most in need of assistance.

The bill 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 seeks to reduce government and, ultimately, taxpayer exposure by insuring against losses through premium

payments which would help fund claims against these guaranteed loans. These claims, payable through FHA would be funded by:

- Imposing a single initial premium payment of 3 percent of the amount of the original insured principal obligation of the mortgage; and
- Assessing the borrower a 1 percent annual premium payment; and
- Requiring that FHA share in the proceeds of any sale of the property.

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. The HOPE Act imposes an initial FHA premium of 3 percent to offset possible losses in the program. Congress might want to examine whether a higher initial premium might be more appropriate given the risk characteristics of the loans under the program.

The equity sharing provisions also should help prevent unjust enrichment to both borrowers and lenders or investors. The required equity sharing would keep borrowers from profiting from an abrupt increase in housing prices if they sell their home or refinance their mortgage and would serve as an additional source of funds to offset losses to the FHA under the program. Likewise, the initial single premium payment will reduce the net proceeds that could be received by lenders or investors.

The HOPE Act 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.

The bill also would establish a program Oversight Board made up of the Secretary of Housing and Urban Development, the Secretary of the Treasury, and the Chairman of the Federal Deposit Insurance Corporation. The Oversight Board would play a key role in the implementation of this program. The Board would be responsible for developing standards within the framework of the legislation, such as establishing affordability requirements. In addition, the Board would be required to establish a structure for an auction to refinance eligible mortgages. Such an auction process would be designed to establish a structure for bulk refinancing of eligible mortgages.

The auction process suggested by the legislation offers a number of opportunities for development by the Oversight Board. While the legislation necessarily leaves many details to be resolved, Congress may wish to clarify the role it intends the government to play in an auction process. Clearly, government agencies could provide a helpful role in sponsoring auctions for private bidders. However, the government as purchaser of the loans would raise significant issues of adverse selection and taxpayer exposure. There also are some significant challenges posed by the securitization structure itself and the Oversight Board will need to develop a process that works within the confines of current securitization contracts. The FDIC uses auction processes for the marketing and sale of many assets from receiverships for insured banks

and thrifts. This process relies on extensive marketing, an opportunity for due diligence, and an open, transparent process for bidding. While an auction process for mortgages from securitization trusts presents some significant differences and challenges, the proposed Oversight Board may want to consider lessons from these procedures.

Finally, the HOPE Act includes provisions to provide servicers engaging in long-term, affordable loan modifications with protection from legal liability from lawsuits by investors. The FDIC strongly supports this kind of safe harbor for loan modification activities. One of the reasons stated for the slow pace of loan modifications is that some servicers remain concerned about the potential for legal liability based on those modifications. Given the flexibility provided in most Pooling and Servicing Agreements (PSAs), it seems unlikely that a servicer engaging in loan modifications to avoid greater losses through foreclosure would be legally liable to investors. In addition, loan modifications that avoid greater foreclosure losses are consistent with industry standards embodied in the principles and guidance provided to servicers by ASF, which should provide an additional degree of protection from legal liability. In fact, servicers who take no action to address upcoming unaffordable resets in their loan portfolios and choose instead to rely on the traditional loan-by-loan process leading to foreclosure, arguably run a greater risk of legal liability to investors for their failure to take steps to limit losses to the loan pool as a whole.

The investor liability provisions of the HOPE Act provide a clear statutory standard regarding servicers' fiduciary obligations. The provisions affirm that any duty servicers have to maximize net present value is owed to all parties in a loan pool, not to any particular parties, and

that a servicer acts in the best interests of all parties if it agrees to or implements a loan modification or workout plan for which: (1) the loan is in payment default, or payment default is reasonably foreseeable; and (2) anticipated recovery under the loan modification or workout plan exceeds the anticipated recovery through foreclosure on a net present value basis. This standard is consistent with most existing contracts and a confirmation of existing law. Importantly, it would not change the servicers' typical contract obligations. In addition, as long as the bill would not abrogate existing contractual rights, this approach should avoid the constitutional "takings" problem.

In general, the HOPE Act 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 HOPE Act 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] The FHA's resources may be significantly stretched to deal with the possible influx of applications arising from this legislation.

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 affect 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

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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.

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* 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

The HOPE Act 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. Significant, direct government intervention into the mortgage markets should be avoided unless absolutely necessary, however, 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 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. The HOPE Act 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, perhaps 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 investors to accept significant losses, and evaluate borrowers based on 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 policymakers 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.

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Statement of

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Office of Thrift Supervision

regarding

Turmoil in U.S. Credit Markets: Examining Proposals to Mitigate Foreclosures and Restore Liquidity to the Mortgage Markets

before the

Committee on Banking, Housing, and Urban Affairs
United States Senate

April 16, 2008

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STATEMENT OF SCOTT M. POLAKOFF
SENIOR DEPUTY DIRECTOR AND CHIEF OPERATING OFFICER
OFFICE OF THRIFT SUPERVISION
ON EXAMINING PROPOSALS TO MITIGATE FORECLOSURES
AND RESTORE LIQUIDITY TO THE MORTGAGE MARKETS
BEFORE THE
SENATE BANKING COMMITTEE

April 16, 2008

I. Introduction

Good morning, Chairman Dodd, Ranking Member Shelby and members of the Committee. Thank you for inviting me to testify on behalf of the Office of Thrift Supervision (OTS) on proposals to mitigate and prevent further home foreclosures in America and to restore liquidity in our mortgage markets. In particular, I appreciate the opportunity to discuss the OTS Foreclosure Prevention Proposal (OTS Plan) and to comment on your bill, Mr. Chairman, the HOPE for Homeowners Act (HOPE Act).

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

In my testimony today, I will focus exclusively on the two subjects at hand – foreclosure prevention and restoring market liquidity to the housing markets. You are well aware of the issues that brought us together today, including the profound changes in the underlying housing market and the impact of the housing downturn on homeowners, financial institutions, and the broader economy. The bulk of my testimony focuses on the HOPE Act and the OTS Plan. Both seek to preserve homeownership and limit preventable foreclosures through the use of FHA loan programs.

The OTS's continuing work in developing and fine-tuning the OTS Plan 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 various players in the mortgage market. These incentives present both obstacles and opportunities that must be considered in fashioning an appropriate strategy for avoiding further foreclosures while restoring liquidity to the mortgage markets. Perhaps the most difficult challenge is the fact that these two objectives – foreclosure prevention and mortgage market liquidity – exhibit policy elements that may tend to run counter to each other (i.e., solutions that

require debt forgiveness by investors may discourage investors' future investments in mortgage securitizations). While both are important policy objectives, the various competing concerns and interests present in minimizing foreclosures and promoting foreclosure prevention highlight important long-term policy implications to long-term liquidity and stability in the mortgage markets.

II. Foreclosure Prevention and Existing 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 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. In contrast, 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.

Next are the 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, 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. 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 mortgage loans performed as expected, but would take the first losses if the loans did not perform as expected.

The interests of the securitizer are also unique. The securitizer will attempt to maintain liquidity in the capital markets for the loans and ensure that the loans are sold at the highest possible value. To accomplish these goals, the proceeds from the sale of the loans will be used to fund future loans, thus potentially providing a stable source of funds in mortgage finance. Of course, the performance of the loans is essential to maintaining regular access to the capital markets for funding and maximizing value. As a result, there is a built-in incentive for the securitizer to insist on proper underwriting. It is primarily the failure of this mechanism that has contributed to the challenges confronting mortgage securitizations today.

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

Loan modification is an important tool in preventing foreclosures; however, as with any foreclosure prevention approach, it may be appropriate for certain situations but not others. The OTS has consistently encouraged the institutions we regulate 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.

Many mortgages are held in securitization trusts that have outside servicers to manage the cashflows arising from the underlying mortgages. Many Pooling and 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 such a modification maximizes proceeds to the securitization trust. We recognize, however, that a loan-by-loan evaluation is time

consuming and will be aided by an articulation of clear guidelines regarding acceptable procedures for structuring write-downs.

There have been a number of initiatives to develop and implement a streamlined loan modification plan, such as that articulated in the American Securitization Forum's December 2007 statement of principles and the efforts of the HOPE NOW alliance. While these efforts have been successful, with HOPE NOW participants reporting over one million loan workouts during the last six months of 2007, issues and obstacles to implementing blanket loan modifications remain a challenge. Reaching borrowers is a challenge with any foreclosure prevention proposal and other issues, such as the potential tax consequences arising under the real estate mortgage investment conduit (REMIC) federal tax rules, present additional obstacles. Another challenge is providing servicers with as much guidance and flexibility as practical to conduct meaningful reviews to identify borrowers in need of assistance. Ultimately, it is important to identify the goals of a foreclosure prevention program and then structure it accordingly.

In our view, structuring a viable loan modification program involves three primary goals that should be recognized and incorporated into any plan. 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 or unexpected life events. 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.

III. Other Approaches to Foreclosure Prevention

The goals central to a viable loan modification program are equally important to the success of any other foreclosure prevention proposal. In addition to providing relief to distressed borrowers and avoiding potentially significant losses to security holders, foreclosure prevention initiatives are 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 a viable foreclosure prevention effort that has 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?
- 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 most likely 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.

Finally, the FHA recently modified its FHASecure refinancing program to allow ARM borrowers who missed two mortgage payments within the past 12 months to participate in the program at a 97 percent loan-to-value (LTV) ratio, and ARM borrowers missing three mortgage payments within the past 12 months to participate at a 90 percent LTV. These modifications will help prevent mortgage foreclosures.

Thus, we have already witnessed a relatively robust government response to encourage new lending, along with other government and 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 that we developed the OTS Plan. 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 and fine-tuning our proposal, 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, Mr. Chairman, given your own legislative efforts to address the problem. In this regard, you have asked for our thoughts on the HOPE Act, your foreclosure prevention proposal.

A. Overview of the HOPE for Homeowners Act

Based on our review of the major provisions of the HOPE Act, it would make available to the FHA such sums as are necessary from 2008 through 2012 to guarantee new mortgages to refinance existing eligible mortgages originated before January 1, 2008, on owner-occupied properties at risk of foreclosure. The proceeds from new FHA-guaranteed loans would be used to pay off existing lenders or mortgage holders after write-down of the existing loan to an amount approximately equal to 87 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 3 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 87 percent of the current FMV of the property (with no recovery of other prepayment penalties or default/delinquency fees).

In addition to the 3 percent FHA origination fee, the borrower must forfeit to the FHA an amount equal to half of any profits from appreciation in the value of the property after the FHA refinancing plus a decreasing percentage (through the fifth year after the FHA refinancing) of the equity in the property created at time of the FHA refinancing (i.e., the difference between the FHA loan amount and then FMV of the property) upon a sale of the property following the FHA refinancing. It is noteworthy that, while the borrower becomes fully vested after five years in the amount of equity created at the time of the FHA refinancing, it appears that the borrower must share with the FHA the amount of any appreciation in the property whenever the property is subsequently sold – and even if the FHA share exceeds the amount of the original write-down required to do the FHA refinancing.

To be eligible for a new FHA-guaranteed loan under the HOPE Act, the original loan holder must agree to accept an amount equal to 87 percent of the current FMV of the property, as highlighted above, 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 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. Overview of the OTS Foreclosure Prevention Proposal

The OTS Plan is designed to avoid 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. The plan was developed with several objectives in mind. First, it was intended as 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. Second, the plan was structured to ensure that the solution minimizes motivations for "gaming" the system by borrowers currently able to pay under their existing loan. A third objective was to avoid providing a windfall to borrowers and investors in the securitization. Finally, the OTS Plan is intended to

identify a solution that optimizes investor incentives and motivations to seek it out while maintaining borrower incentives to preserve the value of the property.

With these objectives in mind, the OTS Plan was developed as a program in which:

- Depository institutions could offer and underwrite FHA-guaranteed loans based on a percentage of the current fair market value of the property (e.g. 90 percent);
- Proceeds of the new FHA loan would be 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 would 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, it was envisioned that 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 OTS plan, the proceeds of the new FHA 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 borrower incentives to preserve the property and maximize its value at sale. The negative equity interest also could be adjusted to provide for a designated percentage to be paid out to an existing second mortgage loan holder to recognize the write-off it would have to make to permit the FHA refinancing to proceed.

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 loan) would be payable to the holder of the negative equity interest up to the full amount of that interest (less any prior second mortgage holder allocation and/or borrower offset to preserve the value of the property), with any sale proceeds beyond the amount of the negative equity interest accruing to the borrower.

The OTS Plan provides a market-driven solution that does not "bail out" investors or borrowers. It allows responsible borrowers to avoid foreclosure and stay in their homes, it allows lenders to underwrite FHA guaranteed mortgages based on acceptable "loan to value" ratios while utilizing current appraised values, and it allows servicers to maximize proceeds for the securitization. Our plan provides an incentive for the original loan holders (including the opportunity for participation by existing second lien holders) and the borrowers to participate in the program. The plan also avoids a windfall to

borrowers by requiring any appreciation in a subsequent sale to 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 (again, less any allowance to a prior second lien holder and any borrower incentive to maintain and maximize the value of the property). And the plan relies on an existing framework – including FHA-insurance – for addressing problem loans in securitizations. Finally, the OTS Plan creates a potentially marketable financial instrument in the negative equity interest.

Following is an example of how the OTS Plan would operate based on a $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., an $180,000 mortgage loan).
- Servicer agrees to take $180,000 partial pay-off in order to maximize proceeds and prevent an unnecessary foreclosure, modifies the original loan obligation down from $220,000 to $40,000, subordinates it to the FHA guaranteed first mortgage, and makes it 0% interest. The maturity of this modified loan (negative equity certificate) is based on either the original maturity or when the borrower sells the property. It is non-recourse with repayment limited to property appreciation when the property is sold. We also believe that there is merit in having the borrower share in appreciation with the securitization trust.
- Borrower has $180,000 FHA-insured fixed interest rate loan with an affordable monthly payment.
- 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 securitization trust (with a percentage to the borrower as an incentive, if applicable) on their negative equity interest in the property.

C. Comparison of the HOPE Act with the OTS Plan

Like the HOPE Act, the OTS Plan is 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 HOPE Act, 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 loans are based on the current FMV of the property is also a key common element of both proposals. Finally, using the proceeds of the new FHA loan to pay existing loan holders via a 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 HOPE Act and the OTS Plan.

First, under the OTS plan, the intent is to provide a negative equity position to the securitization trust in an amount equal to what it charged off by taking the partial pay-off from the proceeds of the new FHA loan. This is intended to 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 HOPE Act would prevent a potential windfall to an existing borrower to a more limited degree, but would also take from the borrower half of any proceeds above the original loan amount if the appreciation in the property reaches that amount. While the HOPE Act would enable a borrower to recoup the entire equity gain (based on the difference in the FHA loan and FMV of the property at the time of that loan) on the sale of the property after five years, the borrower would only get half of any appreciation. Again, it is important to stress that the borrower's half share of any subsequent appreciation remains a half share even for proceeds that exceed the original loan amount.

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. Finally, the OTS proposal does provide an additional borrower incentive by allowing the borrower to keep the sale proceeds in excess of the amount due to the original loan holder (i.e., after payment on the negative equity interest).

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. At the same time, such borrowers would forfeit to the government half of any appreciation above the original loan amount. Arguably, only the government would have a true benefit in this situation – by receiving half of the future appreciation on the property.

Another important difference between the OTS proposal and the HOPE Act 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 loan to minimize the shortfall in the original loan obligation. In contrast, while the HOPE Act 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 3 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 HOPE 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 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 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 Foreclosure Prevention Proposal – subject to further refinements, including ways to improve 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. While the OTS Plan does not require legislation, certainly Congressional endorsement of the approach would significantly facilitate its implementation on a wide-scale basis.

V. Conclusion

Thank you, Mr. Chairman, Ranking Member Shelby, and Members of the Committee, for the opportunity to testify on behalf of the OTS on the HOPE Act and the OTS Plan.

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.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR DODD FROM BRIAN MONTGOMERY

Q.1. There have been a variety of reports regarding the number of loans made under the original FHA Secure program. That program was designed to provide FHA-insured loans to borrowers who became delinquent because of interest rate resets. According to the press report I quoted in the hearing, HUD officials have said that this program has insured only 1,500 loans. In fact, according to a HUD report on FHA activity, "just 242" loans were made for delinquent borrowers (the key parameter of the original FHA Secure program) in the two-week period of March 1 to March 15. Exactly how many loans have been made to date that meet the original parameters of the FHASecure?

A.1. As of May 13, 2008, there have been 3,068 endorsements of loans to borrowers who became delinquent because of mortgage resets and refinanced through FHASecure.

Q.2. In your testimony, you state that the FHASecure and HOPE NOW initiatives have together helped more than 1.3 million homeowners. Please provide the HOPE NOW data that breaks out exactly how many borrowers are getting repayment plans and modifications, and what kind of repayment plans and modifications they are getting.

A.2. As of February, 27 servicers were part of the HOPE NOW Alliance, representing more than 90 percent of all subprime loans and a substantial percentage of all mortgage loans. Results of the HOPE NOW Alliance include:

- An estimated 1,035,000 homeowners were helped to avoid foreclosure from July 2007 through January 2008. This includes 758,000 formal repayment plans and 278,000 modifications. Subprime modifications increased from 19 percent of total workouts in the 3rd quarter and 35 percent in the 4th quarter to nearly 50 percent in January from 19% of total workouts in the 3rd quarter of 2007.
- Since November 2007, HOPE NOW servicers have sent over one million outreach letters to at-risk borrowers who have not previously been in contact with their servicer.
- 16 percent responded in November.
- 21 percent responded in December.
- When servicers send similar letters to their borrowers, the normal response rate is 2–3 percent.
- Homeowner calls have increased to 5,000 per day through the Homeownership Preservation Foundation's Homeowner's HOPE Hotline. Over 37,000 counseling sessions were completed through the Homeowner's HOPE Hotline in the 4th quarter of 2007. To date, the HOPE Hotline has received 456,243 calls, which led to counseling for 165,755 homeowners. Nearly half of those counseled have avoided foreclosure by working out new loan terms or by selling their home.

Q.3. How many people do you expect the expanded FHASecure program to serve? I have seen estimates that range between 100,000

and 500,000. Please provide the analysis that explains how you reached your estimate.

A.3. Our estimate is 500,000 by December 31, 2008. The analysis is based on True Standings data on the mortgage characteristics of current and upcoming mortgage resets of nonprime loans.

Q.4. If I understand your new proposal, the FHASecure program would allow subordinate liens to remain on the homes, leading to combined loan-to-value ratios after the first mortgage is written down and receives FHA insurance of 100% or more. Is this correct? What kind of performance do you expect these loans to exhibit? Please explain the basis for this analysis.

A.4. Allowance for the re-subordination of junior liens has always been FHA policy on refinance loans. There have not been any performance problems associated with that policy. What is new here is to permit the holder of the original first-lien mortgage to create a second-lien position from any excess indebtedness, over what is permissible in a new, FHA-insured first-lien. HUD's performance expectations start with experience with re-performing loans in the FHA portfolio. They are loans that were seriously delinquent (three or more months delinquent) and received loss mitigation work-out assistance. Some of that assistance involved creating second liens on the borrowers' extended arrearages, after HUD brought the loan current via a "partial" claim. HUD expects an 18 percent ultimate claim rate on those re-performing loans, based upon experience to date. Because of the uncertainty surrounding the new loans that will be insured under the expansion of FHASecure, the Administration has decided to score these loans for budget purposes with a 24 percent ultimate claim rate potential. That reflects uncertainties surrounding house price and economic stability in the short run, which is tempered by an expectation that borrower monthly payments will be lower after they refinance—even with a bifurcated mortgage—than they were on the original mortgage.