

**Statement of
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Federal Deposit Insurance Corporation
On
Using FHA for Housing Stabilization
and
Homeownership Retention
before the
Committee on Financial Services,
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Chairman Frank, Ranking Member Bachus and members of the Committee. I appreciate the opportunity to testify on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding proposals to address turmoil in the mortgage markets and stem unnecessary foreclosures. These problems are having serious and growing consequences for our economy. Unfortunately, they defy easy resolution.

The problems facing the U.S. markets are attributable to a complex set of interrelated causes. These include weakened lending standards, inadequate consumer protections, regulatory arbitrage, and speculative activity -- as well as deficient surveillance by rating agencies and inadequate due diligence by originators and investors. No single solution or "silver bullet" can address the adverse effects of these deficiencies. Resolving these issues will require a number of approaches emphasizing different solutions for the different segments of the market. Over the past year, the FDIC has sought to work closely with mortgage lenders, the securitization industry, servicers, consumer groups, other regulators and Congress to identify and correct existing barriers to solving current problems in the markets while establishing controls to guard against their reappearance in the future.

Specifically, the FDIC has aggressively advocated systematic, voluntary loan modifications to address the pervasive problem of unaffordable loans stemming from weak underwriting, particularly in the subprime market. While voluntary loan modifications have shown significant progress, at this point, it must be acknowledged that the pace has not been sufficient to achieve the scale necessary to contain broader harm to communities and our economy.

While unaffordable resets on subprime hybrid adjustable rate mortgages (ARMS) have been addressed through the Treasury-led American Securitization Forum (ASF) framework, pre-reset delinquencies and defaults have been higher than expected, primarily due to a significant deterioration in underwriting in 2006 and early 2007. In addition, unaffordable resets in the Alt-A1 market have begun in earnest, and will continue to rise into 2009. Because of the individualized characteristics of these loans, they do not lend themselves as easily to systematic solutions. Further creativity in

regulatory and legislative efforts is necessary to resolve potential large scale problems in this segment.

Beyond the benefits to borrowers and lenders, minimizing foreclosure will be important to the broader effort to stabilize global financial markets and the U.S. economy. Foreclosure is often a very lengthy, costly and destructive process that puts downward pressure on the price of nearby homes. While lower home prices may be necessary to restore U.S. housing markets to equilibrium, there is a very real risk in this situation that relying too frequently on foreclosure will only perpetuate the cycle of financial distress, risk aversion and declining home prices that we have seen in recent months. As financial market turmoil begins to have a measurable adverse effect on U.S. economic performance, it is becoming clear that foreclosure mitigation must be part of the wider effort to restore stability to our financial markets and strength to our economy.

My testimony will provide a brief update of current mortgage conditions and a description of some key principles I believe are important in evaluating solutions to the problems in the mortgage markets. I also will discuss Chairman Frank's proposal to make greater use of 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 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 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

Policy Responses

For the past year, the FDIC, other regulators, the mortgage industry, consumer groups and Congress have been aggressively engaged in seeking solutions to the problems in the mortgage markets. Several actions, such as issuing guidance regarding problematic loan products and rulemaking to establish national lending standards, have been

focused on preventing future abuses in the mortgage industry. Other proposals have sought to address the existing problems in the mortgage markets that are threatening many borrowers with foreclosure.

With regard to preventing practices in the future that contributed to the current issues in the mortgage markets, strong final rules by the Federal Reserve Board under the Home Owners Equity Protection Act (HOEPA) that impose basic principles of sound underwriting on both bank and non-bank mortgage originators are essential. An important complement to these substantive rule provisions would be the creation by Congress of a federal entity to buttress the efforts of the states to better license and police mortgage originators. This Committee adopted a set of strong licensing provisions as part of H.R. 3915 last year. Similarly, the Treasury Department has proposed creating a Mortgage Origination Commission that, working with state authorities, would develop minimum national licensing qualifications for all mortgage market originators. Although these two approaches differ in some details, their best elements could be merged into a single proposal that would address this urgent issue and command widespread support.

I would emphasize that there is a particular urgency for Congress to act on legislation to establish national licensing standards for non-bank mortgage participants. As interest rates have declined, advertisements are once again promising low "teaser" rates, no-documentation and no-money-down loans, as well as using the term "fixed" in potentially misleading ways to describe the interest rate on variable-rate mortgage loans. Banks are not allowed to market, originate, or fund loans with such weak underwriting, but no such restrictions apply to non-bank mortgage participants nationally. Combined with strong final FRB HOEPA rules, passage of legislation by the end of the year creating a Commission to license and police mortgage originators would help prevent these practices from again misleading borrowers and adding more problems to the mortgage markets.

In addition to preventing harmful lending practices in the future, the FDIC and our fellow regulators are working to prevent unnecessary foreclosures now. These efforts were initially focused on subprime borrowers who occupied their homes and were current on their payments, but were facing future unaffordable interest rate resets. Focusing initially on this group of borrowers made sense because of the immediacy of the risks these borrowers were facing and the potential to reach large numbers of borrowers through systematic approaches. Voluntary systematic loan modifications offered the best option for rapidly addressing the problems of a large number of borrowers.

Before loan modifications could be considered a viable alternative, however, a number of legal, tax and accounting issues needed to be addressed. The FDIC and many others in the government and the private sector laid the necessary groundwork to proceed by removing or clarifying possible barriers and permitting loan modifications to move forward.

The Treasury Department was instrumental in the formation of the ASF framework to provide a systematic approach for restructuring subprime ARM loans for owner-occupied properties where the borrowers are current on their payments but cannot afford the payments following the reset of their interest rates. Restructuring these loans into sustainable loans assists in halting housing price declines prompted by rising foreclosures and vacancies. To date however, this approach has not been fully utilized.

Another option available to as many as 240,000 borrowers is the FHA's FHASecure program, which provides low-cost refinancing options to good borrowers who were steered into high-cost loans with low introductory rates. Both the ASF framework and the FHASecure program, however, apply to distressed borrowers confronting unaffordable resets. In many cases, loan modifications to alleviate resets may not be enough to ensure loan affordability. In addition, the current FHASecure program guarantees loans with extremely high loan-to-value ratios, creating additional government exposure as home prices decline. As we note later in this testimony, a positive feature of Chairman Frank's proposal is the creation of a 15 percent cushion against current appraised value for loans to qualify under his proposal.

Loan modifications were never intended to serve as the sole solution to the problems in the mortgage markets. The intention was that a systematic approach to loan modifications would address some broad categories of borrower problems while freeing up resources to address more difficult cases. In fact, some lenders and servicers have begun to consider additional approaches. For example, consideration is being given to strategies that would forgive a portion of the principal balance to bring payments to a level that borrowers can realistically afford to repay, while at the same time yielding net present values greater than the anticipated net recoveries that would result from foreclosure. I would hasten to add, however, that we do not advocate principal reductions except when necessary to achieve an affordable payment for the borrower. Recent changes to the tax code now allow for mortgage debt to be forgiven without any tax liability on the part of the borrower.

Principles for Solutions to the Mortgage Crisis

In the absence of adequate initiatives to assist distressed borrowers and restore secondary market liquidity, we are very concerned that a continuing cycle of default, foreclosure, home price declines, and uncertainty will occur, leading to further losses and impairing the performance of the U.S. economy. Avoiding this result will require creative approaches to addressing the problems in the industry that recognize the interests of all involved parties. With the wide range of potential options available, it is helpful to establish certain principles as guideposts to assist in the evaluation of ideas and to ensure they achieve the desired outcome. The FDIC believes that programs for resolving the residential mortgage crisis should be guided by the following fundamental principles.

- **The proposals should result in solutions that are sustainable over the long term.** Solutions need to result in long-term, sustainable mortgage payments that

borrowers can afford to pay. Failure to do so heightens the probability that borrowers will not be able to perform under the new terms, causing them to default on the modified loan and lose their home. Making the mortgage sustainable for an individual borrower might require a reduction in interest rates and/or principal sufficient to ensure affordability.

- **The proposals should provide as much fairness as possible and require shared sacrifice on the part of participants.** Any proposal that addresses the current problems in the mortgage markets is going to raise issues of fairness, especially on the part of borrowers who have remained timely on their mortgage payments. However, properly structured proposals will provide benefits beyond the immediate participants by preventing large numbers of foreclosures that would have a broader negative impact on communities and homeowners.

Market participants who benefited most in recent years from many of the practices that have caused the current market problems, should bear a significant portion of the cost of resolving these issues. Otherwise, the result will exacerbate moral hazard and encourage irresponsible lending in the future. By the same token, borrowers who can afford to continue making their payments should do so. Qualifying standards should prevent borrowers who can afford their payments from taking inappropriate advantage of program benefits and should ensure that financial relief is provided to those homeowners who truly need it.

- **The proposals should leverage existing market mechanisms to provide appropriate incentives and avoid delay.** Programs should provide a systematic and streamlined process for reaching as many qualified homeowners as fast as possible. Failure to work with struggling borrowers on a timely basis will contribute to escalating losses for investors, homeowners, and communities. In addition, existing government and market structures, entities, and programs should be used to the extent possible. This eliminates the "start up" time lost when creating new programs and takes advantage of existing expertise.
- **The proposals should attempt to limit the government's liability for future losses.** Lastly, it is essential that intervention minimize government and, ultimately, taxpayer exposure to losses. "Bailout programs" undermine the market discipline that is imposed when lenders, investors, speculators, and borrowers are held accountable for the risks they take. Government refinancing programs, in particular, pose the danger of adverse selection because, once the loan is refinanced out of the securitization pool, the investors bear no further risk of default. Thus, even among a universe of troubled loans, there may be economic incentives to leave to the government those mortgages least likely to perform, and retain those of higher credit quality.

FHA Housing Stabilization & Homeownership Retention Discussion Draft

Chairman Frank recently proposed a new program under the FHA to provide a voluntary mechanism to refinance troubled loans into long-term, sustainable loans. Overall, the Frank FHA proposal ("Discussion Draft") includes many positive features and addresses many of the FDIC's fundamental principles. Essentially, the proposal creates a mechanism where borrowers can obtain affordable, FHA insured loans from new lenders that are accepted as full payment of the existing mortgages by the investors.

Traditionally, FHA provided a mechanism to permit low- and moderate-income consumers to obtain traditional, 30 year fixed rate mortgage financing to purchase homes. Low- and moderate-income lending provides the strongest public policy basis for government support of housing. In recent years, however, FHA products lost market share to private label securitizations. Traditional FHA lending was replaced, especially in subprime markets, by products of dubious design and quality that have contributed substantially to our current problems. Using FHA as the vehicle to refinance some portion of these troubled loans will return FHA to its traditional role of meeting the needs of low-and moderate-income borrowers and stabilizing housing markets.

The Discussion Draft would require that existing mortgage holders agree to accept the proceeds of the FHA insured loans as payment in full of all indebtedness and release all liens. Lenders and investors who stood to profit from these mortgages would absorb substantial losses, as they effectively would settle for 85 percent of the property's current appraised value in full satisfaction of the debt. While this settlement amount represents a substantial reduction for the lenders or investors, the proceeds in all likelihood would still be greater than what could be realized from foreclosure, and would protect the seller against the threat of even greater losses if properties continue to decline in value.

The Discussion Draft also would require that the new insured loans must be properly underwritten and should substantially reduce the existing senior mortgage debt. These requirements would help to ensure that the new loan is sustainable over the life of the loan. The new debt service payments must bear a fixed rate of interest for the entire term of the mortgage and can permit a total debt-to-income (DTI) ratio of up to 40 percent, based on the borrowers' documented and verified income. However, borrowers who have made six months of timely payments that equaled or exceeded the new FHA loan payment amount also would be eligible for higher debt levels. While these underwriting standards will expand the number of eligible borrowers, the FDIC notes that, absent mitigating circumstances, DTI ratios exceeding 50 percent increase the likelihood of future delinquencies or defaults.

Under the Discussion Draft, only owner-occupied residential mortgage loans originated on or after January 1, 2005 and before July 1, 2007 are eligible for consideration. Borrowers must certify that they did not intentionally default on their existing mortgage(s). In addition, borrowers' payments on all existing mortgages must exceed 40 percent of their income as of March 1, 2008. These screening parameters provide reasonable borrower qualification criteria for participation in the program and should ensure that it is targeted to borrowers most in need of assistance.

The proposal strives to protect taxpayers from losses by ensuring that borrowers have a reasonable ability to repay the loan. Despite this safeguard, some mortgages will inevitably default anyway and the FHA will be exposed to credit losses. The proposal minimizes government and, ultimately, taxpayer exposure by insuring against losses through the Special Risk Insurance Fund, which would pay claims against these guaranteed loans. These claims payable through the Special Risk Insurance Fund would be funded by:

Imposing a single premium payment of 5 percent of the amount of the original insured principal obligation of the mortgage;

Assessing the borrower a 1.5 percent annual premium payment; and

Charging an exit premium based on a sliding scale, but a minimum of 3 percent.

These premiums should create a significant reserve against losses on loans guaranteed through the new program. However, it currently is unknown whether the premiums will provide sufficient resources to fund all claims that arise from the insured loans. Losses that exceed the funds available in the reserve would have to be covered by taxpayers.

These premiums also should help prevent unjust enrichment to both borrowers and lenders or investors. The required exit premium will keep borrowers from profiting from an abrupt increase in housing prices if they sell their home or refinance their mortgage within five years of receiving the new loan. Likewise, the initial single premium payment will reduce the net proceeds that could be received by lenders or investors.

Finally, the Discussion Draft approach would make effective use of existing governmental and market structures. By modeling the proposal on existing FHA programs, the time and expense of creating the program are significantly reduced. The proposal also envisions packaging loans into mortgage backed securities guaranteed by the Government National Mortgage Association.

In general, the Discussion Draft addresses many of the principles the FDIC considers necessary for an effective program. It converts current problematic mortgages into loans that should be sustainable over the long-term and convertible into securities. It also requires that investors accept significant discounts and prevents borrowers from being unjustly enriched if home prices appreciate. The proposal uses existing government and market structures which should permit the program to be implemented quickly. In addition, the proposal attempts to provide a financial cushion in the program to help insulate the FHA and taxpayers from losses.

Concerns

Although the Discussion Draft includes a number of positive elements, some difficult issues remain. A major difficulty in refinancing proposals for many troubled mortgages is the significant percentage of them that are subject to second liens. Resolving this issue is essential to ensuring the effectiveness of any proposal. It is not clear what incentives

and processes might be necessary to obtain the agreement and participation of parties holding these second liens.

Another concern relates to the FHA's ability to contend with the potential volume of borrowers seeking participation in the program. The FDIC estimated late last year that almost 1.3 million hybrid loans were scheduled to reset in 2008 with an additional 422,000 hybrid loans scheduled to reset in 2009.¹¹ The FHA endorsed (insured) over half a million single family mortgages for insurance nationwide in fiscal years 2006 and 2007.¹² Even though the proposal provides measures to enhance the FHA's capacity, the agency's resources will be significantly stretched to deal with the possible influx of applications.

A third concern pertains to the possibility of creating the unintended consequence of promoting adverse selection, even within a universe of troubled loans. Lenders and investors might retain loans to higher quality borrowers and submit only those mortgages where the borrowers owe substantially more than the property is worth and/or have demonstrated little ability and/or willingness to repay. While such loans are intended to be considered under the program, a disproportionate concentration of the lowest credit quality will obviously impact FHA loan performance and losses.

A final issue relates to the lack of financial incentive for servicers to modify loans. The governing contract documents, the pooling and servicing agreements (PSAs), generally do not provide any compensation for servicer costs associated with loan modifications. Yet the success of this proposal in achieving scale restructurings to facilitate FHA refinancing will rely heavily on servicers devoting significant resources to writing down the loans.

To address adverse selection as well as the lack of servicer incentives, we suggest that Congress consider requiring the investor to initially settle for 80 percent of the property's current appraised value in full satisfaction of the debt with an additional 5 percent being released to the servicer and investment pool in equal increments over three years so long as the loan continues to perform. The incentives would need to be structured to minimize the potential for conflicts of interest. For the future, we also suggest that the mortgage industry should revise the standard language in PSAs to provide reasonable compensation to servicers for loan modifications in addition to foreclosures.

Additional Suggestions

Title II of the Discussion Draft establishes an outline for an auction system to address troubled mortgages on a bulk basis. As the difficulties that homeowners and the credit markets face are growing, Congress may want to consider additional options that might achieve sufficient scale to benefit large numbers of troubled borrowers and achieve market stability. While auctions can be an effective mechanism for addressing large inventories of assets, it will be difficult to develop an efficient auction structure involving securitized assets and a fair mechanism for establishing value in the current markets.

The financial and market dislocations that have occurred thus far call for bold steps. While significant, direct government intervention into the mortgage markets should be avoided unless absolutely necessary, current circumstances may dictate that the federal government take a more direct role in facilitating solutions for many thousands of troubled mortgages to avoid more dire consequences for all Americans. The direct purchase of mortgages through an auction process, as outlined in Title II, may be one solution if the legal and valuation issues can be resolved. However, there are other options that may help limit government and the taxpayer exposure to future losses.

As mentioned earlier, two of the key principles for crisis management in our market economy are to adopt solutions that operate within existing market mechanisms and to ensure that the ongoing risks are borne by those who stood to gain from the original investment. Since the problems today come from unaffordable mortgages and increasing numbers of homeowners who owe more than their home is worth, optimal solutions would seek to address those issues within existing market structures. Title I of the Discussion Draft is one way of achieving this, by allowing borrowers to refinance into sustainable mortgage loans using this new FHA program.

Another approach may be direct government incentives for principal pay-downs within the existing securitization trusts. Incentives to restructure the mortgages within existing pools through significant reductions in mortgage principal can achieve affordable and long-term sustainable mortgages at today's market interest rates. This can be targeted to benefit borrowers, rather than investors. Importantly, significant reductions in the current principal balance of the mortgages can create new equity for homeowners -- which, as in Title I, could be phased in over a period of years -- that will encourage community stability and reduce the proliferation of vacant homes. By keeping the restructured mortgages in the existing securitization pools, the investors -- not the government or taxpayers -- retain all of the risks of future delinquencies. That is where those risks should be. We would welcome an opportunity to explore such structures with Congress in addition to FHA-based proposals.

Conclusion

The FDIC continues to encourage servicers to work with borrowers to achieve long-term, sustainable loan modifications. This method continues to hold promise, and it would be a mistake for servicers or borrowers who could currently engage in loan modifications to delay their efforts with the hope of getting a better "deal" from Congress or the regulators. Any viable proposal is going to require that investors accept significant losses and that borrowers are evaluated according to their ability to repay.

Nevertheless, loan modifications were never intended to be the sole solution to the problems in the mortgage market. It is appropriate that policy makers carefully consider additional tools for addressing the variety of issues creating uncertainty and volatility in the markets. The FDIC supports long-term solutions characterized by fair apportioning of the costs and risks of modifying or restructuring loans, the use of existing government and market systems, and the mitigation of potential exposure to taxpayers. The FDIC is

committed to working with Congress constructively to identify solutions for establishing values and transparency that will result in healthy and vibrant mortgage markets in the future.

This concludes my testimony. I would welcome any questions the Committee might have.

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.

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.

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.

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.

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 - PDF 4.09M (PDF Help), Fiscal Year 2007, pages 22-23.

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