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

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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.