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Minimizing Losses to Taxpayers"

Chairman Menendez, Ranking Member DeMint, and other members of the Subcommittee, I appreciate the opportunity to testify before you today.

I am the CEO of 1st Alliance Lending, a mortgage origination firm that is a leader in originating FHA loans that offer both affordability and principal reduction. We specialize in these loans, which reduce principal for underwater borrowers and provide affordable monthly mortgage payments.

There are a number of programs and loan options that have been created in the last several years to help troubled homeowners – including HAMP loan modifications, HARP Fannie Mae and Freddie Mac refinancings, FHA streamlined refinancings, and assistance to unemployed homeowners. While these programs address affordability, generally they do not provide for principal reduction. We argue, and our experiences substantiate, that principal reduction is critical, in concert with affordability efforts, in providing long term solutions to American homeowners. Moreover, we are finding that sophisticated financial entities with their own money at risk in the mortgages are using principal reduction in a targeted manner to maximize the recovery value of these mortgages. There is a growing consensus that supports these conclusions, and I appreciate the opportunity to share our experiences on this subject.

According to Core Logic, at the end of 2011, 11.1 million homes (over 23% of all homes nationwide) are underwater. A home is underwater when the amount of the mortgage or mortgages a homeowner has on their home exceeds the value of that home. It is hard to see how we can address our underlying housing problems and restore health to housing markets without addressing this issue.

Homeowners who are underwater are house-locked - unable to sell their home should they need to move for new employment, or any other reasons. Homeowners who are significantly underwater, particularly in areas where housing prices are less likely to recover, face the prospect of a very long period in which they will have no equity in their home. HAMP and other proprietary loan modifications address affordability problems, but even HAMP assistance phases out over time and ultimately borrowers receiving payment modifications will continue to be faced with the challenge of negative equity.

An often overlooked fact is that principal reduction, done correctly and in a targeted manner, is sometimes the best economic option for the holder of the mortgage; and often significantly enhances the value of the asset. In fact, we increasingly see holders of underwater mortgages utilizing principal reduction as part of their asset maximization efforts. These are sophisticated counter-parties, acting in their own financial interest. Of course, where they utilize this option, it is also good for the homeowner, and by extension, for housing markets by reducing the risk of default and foreclosure.

1st Alliance Lending works with a number of major banks, investment banks, and sophisticated financial counterparties who hold or purchase pools of single family loans, including loans to currently distressed and underwater borrowers. 1st Alliance analyzes these pools of loans to identify borrowers who qualify for our programs and for whom it makes sense financially to utilize this option. We have utilized FHA refinance principal reduction programs, which provide opportunities for these types of distressed homeowners to refinance their existing loan, but only if the existing first mortgage holder forgives a portion of the principal in order to meet FHA's loan to value (LTV) requirements.

For homeowners that qualify, we do far more than the calculations that are done for loan modifications; we do a complete underwrite. Unlike the typical loan modification analysis, we don't just make sure a homeowner's loan payments are affordable, we also address subordinate liens; often extinguishing multiple liens through our transaction. We analyze the borrower's total debt burden and income, to make sure the homeowner is financially sound and capable of meeting their debt obligations. These steps are important in reducing re-default and foreclosure risk, because modifications which focus only on the payment affordability of the first mortgage loan do not take into account the financial stress of other debt that the homeowner has that can negatively impact their ability to pay their first mortgage.

Again, let me emphasize – these investors and mortgage holders that we work with agree to principal reduction in these situations voluntarily. Moreover, they make the decision to do principal reduction not out of a sense of charity, but because they believe it is in their best financial interest to do so. They are sophisticated, and are doing these transactions to maximize asset value.

1st Alliance has been underwriting FHA loss mitigation loans long enough that we now have a track record, with seasoned loans. From the perspective of the FHA, I am pleased to report that our default rates on these loans are in the single digits. This performance rate is significantly better than original program projections for FHA principal reduction loans, and much better than re-default rates in the HAMP program, and we believe even better than for proprietary mods without principal reduction. This performance, we contend, shows the powerful impact of principal reduction.

There has been much discussion over the last few years about the role of Net Present Value, also known as NPV, in determining which borrowers should be candidates for any assistance, and, whether or not to use principal reduction as part of a loan modification. I would point out that NPV results are highly dependent on assumptions you feed into the calculation. I would further point out that many sophisticated market players, with their own money at risk, have made the business decision that principal reduction does make sense for certain segments of their portfolios. Therefore, although parties like the FHFA have used NPV calculations to conclude that principal reduction is not justified (in their case, for Fannie Mae and Freddie Mac loans), I would suggest that they if they have doubts about the value of principal reduction, they need not commit wholesale to principal reductions, but could start by dipping their feet into the water on a pilot or limited basis, to test out how and whether principal reduction is effective.

Finally, I would like to address the issue of moral hazard. Moral hazard is where individuals or firms engage in risky or careless conduct because they are insulated from the consequences of such conduct. Over the years, there has been extensive discussion about government intervention and moral hazard – during the reckless lending period by allowing zero down and no document loans; in 2008 by bailing out financial institutions through TARP; post crisis by helping homeowners who have become distressed; and even now as we discuss targeted principal reduction.

I am not here to debate the question of whether or not to help distressed homeowners, except to note that since early 2009 we have put in place a number of federal programs to do so. I am here to discuss how to help homeowners fairly and effectively. As my testimony indicates, I believe principal reduction should be a component of any comprehensive loss mitigation program. To the more specific criticism, that we are engaging in moral hazard by giving homeowners an incentive to stop paying their mortgage, I emphasize that is not our experience. Our borrowers have experienced an objective adverse event over which they had little or no control, such as a loss of income or a serious health issue or problem; a true and validated hardship. None of our borrowers are suspected of intentional default.

I am not here to advocate for beneficial loans for irresponsible homeowners. I have come here to testify to the effectiveness of targeted principal reduction, and its role in any responsible and comprehensive loss mitigation strategy. I would argue that it is very effective; and I believe the experience of my firm shows how responsible, targeted principal reduction can not only be good for the homeowner, the housing market, and our communities, but also good for the holders of the existing mortgages.

Thank you again for the opportunity to testify today.