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TESTIMONY

OF

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COMPTROLLER OF THE CURRENCY

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

OF THE

U.S. HOUSE OF REPRESENTATIVES

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Statement Required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent those of the President.

I. Introduction

Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify today concerning the proposed FHA Housing Stabilization and Homeownership Retention Act of 2008 (Act), which Chairman Frank recently circulated for discussion. Where a distressed borrower could no longer afford his or her mortgage, the Act would establish a new program that would provide the borrower and the holder of his or her mortgage with an alternative to the costly prospect of foreclosure: if the borrower and mortgage holder agreed and the borrower met certain criteria, the mortgage holder would reduce the mortgage principal to an amount that would be affordable for the borrower; the mortgage holder would accept the corresponding loss; and the mortgage would then be refinanced into a new FHA-insured mortgage product at the lower amount. The hope is that the alternative would be less costly than foreclosure for many such loans, which would be the incentive for mortgage holders to agree to it; that it would allow borrowers to remain in their homes with lower mortgage payments, which would be their incentive for agreeing to it; and that the written-down mortgage would be an acceptable risk for the government to assume in order to lessen the prospect of widespread foreclosures and all their related costs.

Having such an option available to the national banks supervised by the OCC, whether acting as mortgage holders or servicers, raises few safety and soundness issues because the program is voluntary. Indeed, if the option proved to be an attractive and less costly alternative to foreclosure as intended, it could save national banks significant amounts over time. And by keeping more borrowers in their homes, the widespread use of such a program could also help avoid further reductions in the prices of houses

financed by national banks more generally – making the mortgages less risky – by mitigating the downward pressure on house prices caused by the foreclosures that would be avoided.

The degree to which borrowers and mortgage holders would actually choose this new voluntary option is not clear, however. Based on our analysis of the particular features of the legislation and discussions with the national banks most active in the mortgage markets, there could be a number of situations in which the new option would not be an attractive alternative to foreclosure, despite its steep costs. This is due to a mix of factors that we describe in Section IV of our statement, which also includes our comments and suggestions. That discussion is preceded, in Section II, by our observations about recent developments affecting foreclosure rates, and, in Section III, by a brief discussion of the framework of the proposed legislation to provide a context for our comments in Section IV.

II. Foreclosures in the Current Climate

As has been widely reported, there were 1.3 million mortgage foreclosure starts in 2007. This was slightly more than double the average rate for the first half of the decade, which averaged 650,000 foreclosure starts per year from 2001 through 2006.[1] There are concerns that total foreclosure starts will increase to as much as 2 million in 2008, although it is possible that favorable changes in interest rates on adjustable rate mortgages (ARMs) may reduce this number. Subprime mortgages are a small percentage of the outstanding mortgage universe, but eclipse other types of mortgages in the

[1] The average quarterly rate of foreclosures started as a percent of loans outstanding from 2001-2006 was 0.44 percent, increasing to 0.71 percent in 2007, an increase of 27 basis points, or 61%. OCC staff bases this estimate on loan servicer survey data collected by the Mortgage Bankers Association.

foreclosure process. The onset of subprime defaults has jolted investors and triggered a far-reaching reassessment of risk across financial markets.

Today's hearing takes place in the context of a number efforts to meet the challenges presented by rising rates of foreclosure in the United States. The Hope Now Alliance and the American Securitization Forum have developed protocols and criteria that facilitate streamlined modification of securitized ARMs. Banking regulators have issued guidance encouraging servicers and lenders to pursue loan modifications instead of instituting foreclosure, when feasible and prudent. The FHASecure plan offers qualified mortgage borrowers that are in distress because of interest rate resets on ARMs the chance to refinance into new FHA-insured mortgages. Congress and the Administration have temporarily increased the maximum loan amount for FHA mortgage insurance, which makes the option available to borrowers in higher-cost housing communities for the first time. Community organizations and homeownership counseling groups are reaching out to distressed borrowers to assist in implementing these approaches, and banks are partnering with these organizations to try to reach more of their customers.

Adding momentum to these efforts has been the projected "payment shock" affecting subprime and Alt-A borrowers that is expected when initial fixed interest rates on hybrid ARMs "reset" to higher variable rates, with corresponding large increases to borrowers' monthly payments. This occurred in 2007, when resets typically resulted in payment increases of 25 percent or more. Expectations were that a much larger group of resets in 2008 would expand the group of distressed borrowers. However, since the beginning of the year, there has been a steep decline in short-term rates, and the indices

on which rate resets are based have fallen significantly. For example, six-month LIBOR was cut nearly in half, to fall below 3 percent. If rates remain low, depending on the type of loan product and its particular terms, many borrowers will experience much smaller or nominal payment increases and their mortgages will remain affordable.[2]

Of course, borrowers in the subprime and Alt-A sector continue to face substantial uncertainties. Early defaults by some subprime borrowers, even before their first interest rate reset, likely reflect the consequences of poor underwriting, or in some cases even fraud. For other borrowers, who may avoid payment shock on their ARMs in current market conditions, there remains the prospect of future loan rate and payment increases as short-term market rates eventually rise.

In addition, as a consequence of product terms and underwriting standards in prior years that allowed borrowers to obtain loans at or very near the full value of the property, recent property value declines leave borrowers owing more than their homes are currently worth – a situation often described as "negative equity." While this trend should eventually reverse and restore positive equity to these borrowers, it currently impedes refinancing into more affordable mortgages. And even if this were not the case, the market's return to more fundamental mortgage underwriting standards may make it difficult for many of these borrowers to refinance on affordable terms.

For these reasons, there is unlikely to be a single solution that can successfully address the multiplicity of competing interests at stake, and the differing circumstances

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[2] *See* B. Grow, A. Zimmerman, and J. Kahan, *The Mixed Impact of Falling Rates on U.S. Alt-A and Subprime Borrowers* (Standard & Poor's RatingsDirect, March 26, 2008) (at March 2008 six-month LIBOR rates, "payment shocks" on average two-year hybrid ARMs reduced 95 percent; reduced 50 percent for average 3-year hybrid ARMs; and payment shock virtually eliminated on average Alt-A hybrid ARMs).

facing millions of borrowers. Thus, the introduction of new options, such as the new program initiated by the Act, could prove very constructive.

Moreover, thanks to data-collection efforts undertaken by the Hope Now Alliance, we are beginning to have a clearer picture of the dimensions of borrower defaults on subprime mortgages and the types of remedial activities being pursued by servicers in light of borrowers' circumstances. The OCC also is requiring our largest national bank mortgage servicers to provide comprehensive mortgage data that should contribute significantly to our understanding of loan delinquencies and defaults, and of efforts to prevent unnecessary foreclosures. We expect the data will cover more than 95 percent of all mortgage servicing activity in the national banking system; that is, it will not be limited to subprime mortgages serviced in securitization pools. The OCC is requiring this comprehensive mortgage data in order to ensure that we have a detailed picture of the activities of national bank servicers, the performance of loans serviced by them, and the types of foreclosure mitigation activities that seem to be workable.

III. The FHA Housing Stabilization and Homeownership Retention Act of 2008

The Act would provide an opportunity for many subprime and Alt-A borrowers to seek FHA-insured refinancing of their current loans on an affordable basis from private lenders under a new FHA insurance program. Refinancing would require that the servicer (or other holder) of the current mortgage voluntarily agree to accept the proceeds of the refinanced loan in full satisfaction of the borrower's obligation on the current mortgage. Those proceeds will be substantially less than the borrower's obligation under the current mortgage (commonly referred to as a "short payoff").

The FHA insurance coverage under this new program will be handled through a new fund, separate from the existing FHA insurance fund. The new fund will be financed through an initial insurance fee (not to exceed 5 percent of the insured loan amount) paid out of the refinancing proceeds on the current mortgage holder's behalf; an annual fee (not to exceed 1.5 percent of the outstanding loan balance) to be paid by the borrower; and a contingent exit fee to be paid by the borrower. This contingent exit fee will be payable to FHA upon subsequent sale or refinancing of the property only to the extent there are proceeds from the disposition left over after paying off the insured loan. The exit fee will generally be 3 percent of the original insured loan amount. However, during the first year of the refinancing, FHA would be entitled to all the net proceeds, and would continue to be entitled to a portion of the net proceeds in years two through five, declining by 20 percent each year. FHA's contingent claim would be secured by a second lien (commonly referred to as a "soft second") on the property. In addition, all existing mortgage holders – including holders of a second mortgage, such as from a "piggyback" purchase financing transaction or a home equity line – would have to agree to release their liens in order for the FHA refinancing to go forward.

The insurance program will be available for loans originated from January 1, 2005 until July 1, 2007 on 1- to 4-family properties. Only loans securing the borrower's principal residence are eligible, and the borrower's ratio of total mortgage debt to documented income as of March 1, 2008, must be at least 40 percent. The new loans will not be eligible for FHA insurance unless they are fixed-rate loans at current market rates, and the loan amount does not exceed 90 percent of the property's current appraised value. The loan must be underwritten based on the borrower's documented and verified income,

under terms established by HUD ensuring the borrower has a reasonable expectation of repaying the loan. The borrower's total debt obligations, including the new mortgage and other commitments, generally may not exceed 40 percent of income, though this figure may be somewhat higher if the borrower previously made similar payments for six months.

Title II of the Act establishes an Oversight Board comprised of the Secretary of the Treasury, the Secretary of HUD, and the Chairman of the Federal Reserve Board. This Board will establish an auction or other bulk facility that allows holders of mortgages to place group bids on FHA-insured refinancing of their loans. The auction facility will be available if the Board determines its use is necessary to stabilize the housing market and reduce the impact of turmoil in that market on the economy.

Title III of the Act would authorize appropriation of $10 billion in funds for grants to states for purchasing foreclosed properties at a discount and loans to individuals or entities seeking to acquire these properties for use as residences.

IV. Discussion of the Proposed Legislation

The Act is premised on a voluntary approach, under which servicers, acting on behalf of MBS investors and lenders holding loans on their balance sheets, will determine how to proceed. This is prudent and appropriate. Alternative approaches that would affect existing contracts could create litigation risks, and alteration of the fundamentals of agreements relied upon by mortgage lenders and investors could further retard confidence in and recovery of the secondary mortgage markets.

The usefulness of the approach taken in the proposed legislation would also be enhanced by provisions, like those in H.R. 5579, recently introduced by Representatives

Castle and Kanjorski, that clarify the obligations of servicers and provide reasonable and limited protection from liability for undertaking loan modifications, workouts, or principal writedowns. Servicers working with distressed borrowers face the difficult task of balancing the interests of borrowers and investors. Servicers perform these tasks in the context of pooling and servicing agreements that outline their contractual duties to investors in administering loan pools. H.R. 5579 would clarify that servicers should take actions that benefit all pool investors in the aggregate under these agreements. The alternate interpretation – that servicers cannot take action when it would result in conflicting impact on different classes of investors – could effectively paralyze servicers from taking any of the remedial actions specified in the agreements.

In short, the Act's approach is to offer FHA insurance that will make refinancing possible for an expanded group of borrowers on terms acceptable to current mortgage holders. Its success will hinge on a combination of factors, which may be complex. My testimony next highlights the factors we see as crucial to the scope and scale of implementation of the new program, and offers some suggestions.

<u>Concessions from Current Mortgage Holders</u>

The bill requires concessions from current mortgage holders, including principal writedowns and fee waivers. From the servicer's standpoint, these concessions may make sense if they will bring in funds that exceed (on a net present value basis) what the servicer can reasonably expect to obtain through other options. If the servicer is working with a borrower headed for foreclosure, the servicer can expect to have outlays for legal fees to obtain title to the property; expenses related to maintenance, taxes, and insurance; advances to investors for unpaid interest that continues to accrue on the mortgage;

marketing expenses for the property's resale; and most significantly, to sustain losses for the difference between the loan amount and the property's subsequent sales price. There can also be a lengthy period before foreclosure, during which the borrower makes no payments on the loan, and the overall period between default and subsequent sale of the property discounts the value of the proceeds eventually realized. State-by-state variations in procedures for trustee sales, deed-in-lieu, or judicial foreclosure affect these costs. Depending on the circumstances, these total costs and losses can be significant. Information from national banks active in mortgage servicing indicates that these losses (consisting of uncollected principal and unreimbursed outlays of the type described above) are typically in the 40 percent range, but will vary significantly depending on various factors.

If anticipated recoveries on foreclosure are less than the refinancing proceeds available to the current mortgage holder under the new program outlined in the Act, it would be rational for the servicer to choose the refinancing route. Before making this decision, however, the servicer is likely to assess borrowers' circumstances and evaluate their capacity to meet their existing mortgage obligations on modified terms instead. For example, modifications to subprime and Alt-A loans that make reasonable adjustments to the interest rate and term of the current mortgage can reduce a borrower's payment, without principal reduction, to the same amount it would be under a new loan for 85 percent of the existing principal amount. This allows borrowers to stay in their homes without any principal concession by investors. Moreover, we understand that investors are currently demonstrating a strong preference for rate and term modifications over principal concessions.

If, however, such modifications are not a viable alternative, the attractiveness of the refinancing option under the Act will depend on the extent of the principal compromise required. Under the Act, investors (and other current mortgage holders) would make principal concessions that equal the difference between the current mortgage loan balance and the proceeds of the new loan. The new loan amount will depend on two main factors that will vary from loan to loan: the current property value, and the size of the loan the borrower can incur consistent with the Act's underwriting standards. The loan proceeds ultimately retained by the current mortgage holder will also be reduced by the 5 percent insurance fee payable to FHA, and the amount of funds the servicer must advance to cover the borrower's payment deficiencies during the time it takes to arrange for refinancing of the defaulted loan, as well as other expenses. The full extent of the current mortgage holder's net principal loss can vary considerably under these factors, as illustrated in this example:

<u>Original Loan: $250,000 30-year ARM at 8 percent initial rate</u>

Property value:	$250,000
Borrower monthly income:	$3,500
Monthly payment:	$1,834
Mortgage debt-to-income ratio:	52%
Current loan balance:	$245,000

Example 1: Level Market, Level Income

- The Act imposes a 90 percent maximum on the loan-to-value ratio for the refinancing loan. If the value of the borrower's home has not declined since the original loan was issued, this would support a new loan amount of $225,000.
- However, the monthly principal and interest payments on a new fixed-rate 30-year mortgage at the current market rates for comparable loans (8 percent) would be $1,650. This would exceed the Act's underwriting ratio for borrower income, which generally limits the borrower's total debt to 40 percent of income.
- At the Act's 40 percent debt-to-income ratio, the borrower would be able to make payments of as much as $1,400 per month. This would support a new fixed-rate 30-year mortgage at 8 percent in the amount of $190,797:

Current loan balance:	$245,000
Less: new loan proceeds	$190,797
Less: 5% FHA fee	$9,540
Less: Servicer advances[3]	$14,167
Net proceeds recovered:	$167,090
Net loss percentage:	32%

- The Act allows increase of the 40 percent debt-to-income ratio to 50 percent if the resulting payments do not exceed payments the borrower successfully handled for

[3] Under pooling and servicing agreements, when a borrower has stopped making payments on a loan, the servicer is obligated to advance the interest accruing on the loan to investors, out of the servicer's own funds. The servicer must also advance its own funds to cover taxes and insurance on the property, and to cover all processing expenses. These examples assume the servicer would advance interest for 4 months (2 months delinquency and 2 months to completion of the refinancing), and that taxes, insurance, and other expenses would total 3 percent of the loan amount. The example does *not* include prepayment fees or penalties, which are to be waived under the bill.

six months under the current loan. The ratio can be increased even more, to 55 percent, if the increase is necessary to achieve the purposes of the Act and can be accomplished under reasonable underwriting standards. If we increased the borrower's debt-to-income ratio to 50 percent, with a payment of $1,750 a month under the same loan, this would support a new loan of $238,496:

Current loan balance:	$245,000
Less: new loan proceeds	$238,496
Less: 5% FHA fee	$11,925
Less: Servicer advances	$14,167
Net proceeds recovered:	$212,405
Net loss percentage:	13%

- Note, however, that this leaves the borrower with a payment that is only $84 less than the payment he or she already failed to meet on an intermittent basis. It also assumes that the borrower has no other debt to service, allowing half of his or her income to be allocated to servicing the new mortgage; this will not likely be the case for subprime borrowers, who typically have other debt.

Example 2: Income Re-underwriting

- Another factor affecting these outcomes is the Act's requirement to base the refinanced loan on documented borrower income. Many subprime and Alt-A borrowers have relied to a significant extent on undocumented income to qualify for their mortgages and make the required payments.

- If the borrower cannot document 25 percent of his or her original income, and must pay $350 each month on other auto and credit card debt, the funds available to service the new mortgage at a 50% debt-to-income ratio drop to $963, supporting a new loan of $131,241:

Current loan balance:	$245,000
Less: new loan proceeds	$131,241
Less: 5% FHA fee	$6,562
Less: Servicer advances	$14,167
Net proceeds recovered:	$110,512
Net loss percentage:	55%

Example 3: Declining Property Values:

- Given current market conditions, the property securing the current mortgage is unlikely in the short term to remain at its original value. As the property's value declines, the 90 percent loan-to-value limit in the Act begins to affect the current mortgage holder's recovery. If the property in our example has declined by 20 percent in value, consistent with current declines in certain areas of the country[4] and with property values in certain high-risk neighborhoods, it would now be worth $200,000. This would support a new fixed-rate 30-year mortgage at 8 percent in the amount of $180,000:

[4] One widely-reported home price statistic, the S&P/Case-Shiller Home Price Indices, tracks repeat sales in 20 U.S. metropolitan markets. These indices report 20 percent declines from 2006 peaks for three metropolitan areas as of January 2008. The composite index reports declines of 12 percent for the same period.

Current loan balance:	$245,000
Less: new loan proceeds	$180,000
Less: 5% FHA fee	$9,000
Less: Servicer advances	$14,167
Net proceeds recovered:	$156,162
Net loss percentage:	37.75%

As these examples demonstrate, investors' net losses can range from 10 to 55 percent, depending on circumstances and conditions. As compared to foreclosure costs averaging 40 percent, but which will vary significantly depending on various factors, the Act may not provide sufficient incentives for investors in some cases. Much depends on currently uncertain factors inherent in the Act's refinancing formula, particularly with respect to future property values, and with respect to actual refinancing loan amounts derived after application of the Act's borrower eligibility and underwriting standards to actual borrowers.

In addition, we are hearing anecdotal expressions of concern from some servicers that delinquent borrowers may seek the benefits of the program aggressively, even though they may have the capacity to pay their current mortgages under repayment plans or rate and term modifications, without the necessity of significant principal writedowns. Under the Act, a borrower would be eligible for participation in the program if his or her total mortgage debt constitutes at least 40 percent of documented income as of March 1, 2008, and if the borrower certifies that he or she has not intentionally defaulted. Significant numbers of current subprime and Alt-A borrowers would likely exceed this 40 percent threshold, given underwriting practices for these types of mortgages in prior

years and the widespread reliance on undocumented income by these borrowers to qualify for and make payments on these mortgages. Some servicers have expressed concern about the prospect of borrowers that meet the eligibility threshold who are current on their payments, thereby demonstrating their capacity to repay, deciding not to repay based on negative equity and the availability of the new program; that is, instead of continuing to repay they would refuse to negotiate on any basis other than a significant principal writedown.

The Problem of Second Mortgages

Another key issue faced by the proposed program under the Act, or any voluntary refinancing alternative for that matter, is how to deal with second mortgages. Industry data indicate that at least 30 percent of subprime mortgage borrowers also have a second mortgage, and the actual percentage is likely to be significantly more than 30 percent.[5] The bill authorizes HUD to take action as necessary and appropriate to facilitate coordination between senior and subordinate mortgage holders to facilitate their agreement to accept the proceeds of the refinancing loan as a short payoff and release their liens. Release of all existing mortgage liens is a prerequisite to insurance eligibility under the bill. Voluntary participation by any holder of a subordinate mortgage on each property therefore is just as essential to the program's success as voluntary participation by the senior mortgage holder. However, senior and subordinate mortgage holders have very different incentives that can impede their joint consent.

Recent declines in property values have left many subprime and Alt-A borrowers with insufficient equity in their properties to cover both their first and second mortgages,

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[5] OCC staff bases this estimate on selected LoanPerformance data on the loans underlying securitizations comprising the following indices: ABX-06-1; ABX 06-2; ABX 07-1; ABX 07-2. However, the selected data may underreport second mortgages.

with the value of the home less than the value of the first mortgage. In such circumstances, the first mortgage holder remains at least partially secured by the reduced value of the home, while the second mortgage holder becomes unsecured until such time as the value of the home increases. Thus, even if the borrower is behind on the second mortgage, the holder is interested in avoiding foreclosure. That is, if foreclosure occurred immediately, the second mortgage holder would get nothing, while a delay in foreclosure would allow for both the possibility that the borrower's situation may improve over time (enabling resumption of payments and cure of the prior default) and the likelihood that property values will eventually recover and restore equity to the second lien. Even if property values only recover enough to restore partial equity to the second lien, the lender may be able to obtain a sizeable compromise payment when the borrower later wants to refinance or sell the property and needs the second mortgage holder to release the lien to clear title.

If foreclosure on the first mortgage is truly imminent, then the second mortgage holder is facing the prospect that its lien will be extinguished, resulting in an unsecured claim against the borrower for the debt. In those circumstances, a second mortgage holder has an incentive to accept a portion of the short payoff proceeds from a refinancing transaction under the bill, if that payment exceeds the second mortgage holder's expected recovery on the unsecured debt, which is likely to be low. Otherwise, however, a repayment plan or modification by the first mortgage holder is more consistent with the second mortgage holder's interests in retaining its position.

As a result, a second mortgage holder may lack incentives to release its lien to facilitate refinancing, unless a portion of the refinancing proceeds are used to make a

meaningful compromise payment on the second. However, this reduces payments to the first mortgage holder by what could be an unacceptable amount, given the first mortgage holder's concerns about principal concessions discussed above.

This suggests that it will be essential to understand the concerns that second mortgage holders have and to identify incentives they regard as workable. Otherwise, borrowers' inability to obtain their concurrence to refinancing is likely to delay and diminish the availability of relief under the Act. Issues include identifying ways to demonstrate that foreclosure is truly imminent and the second mortgage holder's expectation of recovery is small, indicating compromise for a smaller portion of the refinancing proceeds is warranted. In other circumstances, it may be advisable to allow a second mortgage holder to retain a subordinated lien for some amount on the property, but suspend the borrower's payment obligations until the future. The Committee may wish to consider adding explicit provision for this option in the Act.

Another issue, albeit one that arises less frequently, is that the second mortgage portfolios of a selected number of lenders are covered by private mortgage insurance (PMI). In this context, PMI typically provides partial first-loss coverage to the second mortgage holder. This coverage is usually paid after the foreclosure process has run its course, so that the amount of the lender's losses can be conclusively determined. What this means is that the second mortgage holder consenting to a non-foreclosure alternative could be facing the loss of a very substantial cash payment from the PMI insurer, unless the PMI insurer is willing to pay coverage based on the lender's write-down claim. Accordingly, further dialogue on second mortgage issues with interested parties should include the relevant PMI issuers.

Other Considerations

The Auction Facility. Title II of the proposed legislation leaves details about structure and function of the auction facility to be determined by the Oversight Board it establishes, so my comments necessarily only address several general and practical points. The auction facility is another promising tool to accomplish mortgage refinancings, potentially on a volume basis, but it would appear to present several practical issues. As an operational matter, institutions making bids to refinance groups of loans under the FHA's insurance programs will need underwriting information about the loans in order to determine a bid. Underwriting criteria for the insurance programs will therefore need to be geared to information the current mortgage holder has access to and can make available through the auction facility. Where this information involves uncertainties or qualitative judgments, the facility may need to incorporate pre-closing adjustment mechanisms such as put-backs that could impede overall efficiency of the process. The purchaser will otherwise be subject to the risk of becoming the owner of loans that do not qualify for FHA insurance. If such a purchaser depends on a warehouse line of credit to finance the loans pending closing of the refinancing transactions, its warehouse lender will be subject to similar risks.

Borrower Eligibility and Refinancing Criteria. Designing the borrower eligibility and underwriting standards involves a quite difficult balancing of competing concerns. On one hand, as previously discussed, conservative underwriting standards lead to significant reductions in the principal balance of the refinancing loans, and servicers are less likely to consider the option preferable to foreclosure, thus thwarting the Act's objectives. Importantly, however, insufficiently rigorous standards carry the risk of

further financial pain for borrowers and the risk of redefault (and resulting in increased losses to FHA and to lenders who participate in the refinancing part of the transaction). Additionally, changes in market factors (such as recent declines in short-term interest rates, for example) can have unexpected effects on borrower circumstances. Similarly, overly conservative standards for borrower eligibility can thwart the bill's objectives, while unnecessarily generous standards increase risk to the FHA.

The Committee may wish to consider building more flexibility into HUD's role in setting these standards. As an alternative, the Act might set a range for more of these standards, with HUD authority to establish – and adjust – the applicable standard. If experience with the program indicates it is not functioning as anticipated, or market conditions alter the landscape, this flexibility could be instrumental in making adjustments to achieve the Act's objectives.[6]

FHA Second Lien. The Act indicates that the borrower's obligation to pay the FHA under the soft second is limited to any net proceeds resulting from a sale or refinancing that remain after deducting the remaining balance of the FHA-insured loan. If a borrower obtains refinancing for the outstanding balance of the FHA-insured loan (such as many borrowers do when they refinance the existing balance to take advantage of declines in market interest rates), there will be no net proceeds available under the Act's formula, and the borrower will owe the FHA nothing. Similarly, nothing under the Act prohibits a borrower from entering into a collusive sale of the property to a related party at a price just sufficient to cover the outstanding balance of the FHA-insured loan,

[6] If the Act retains the test establishing the borrower's lack of capacity to pay at a 40 percent mortgage debt-to-income ratio as of March 1, 2008, consideration should be given to normalizing borrowers' outstanding obligations through a standard scale, such as a 30-year amortizing fixed rate calculation.

leaving no net proceeds under the Act's formula and no obligation to the FHA. These are topics where the legislation could direct HUD to develop standards to prevent windfalls and abuses.

Conclusion

In summary, alternatives to foreclosure can benefit borrowers, lenders, and investors. Designing alternative approaches that are both workable and fair, and aligning incentives to be sufficiently responsive to the needs of all the stakeholders, is a complex and delicate task. My testimony has outlined some ways in which the incentives the proposed legislation provides may warrant refinement – particularly the factors affecting the requirements for concessions from current mortgage-holders, and the need for incentives appropriate to obtain participation by second-lien holders. But the more options stakeholders have to address payment default, including through the proposed legislation, the greater the chances that foreclosure can be avoided.

We would be pleased to work with the Committee as the legislation is further developed to explore these and other issues.