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"The Recently Announced FHA Refinance Option for Underwater Borrowers and Revisions to the Home Affordable Modification Program (HAMP)"

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U.S. House Committee on Financial Services
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Chairwoman Waters, Ranking Member Capito and members of the Subcommittee, thank you for the opportunity to testify today on the recently announced adjustments to Federal Housing Administration (FHA) programs that will permit lenders to provide additional refinancing options to homeowners who owe more than their home is worth because of large falls in home prices in their local markets.

These adjustments will provide more opportunities for qualifying mortgage loans to be responsibly restructured and refinanced into FHA loans as long as the borrower is current on the mortgage and the lender reduces the amount owed on the original loan by at least 10 percent. A second lien writedown program will be paired with these changes to encourage further writedown of second liens to further assist homeowners reduce the amount of negative equity they have in their homes. These program adjustments will better assist responsible homeowners who have been affected by the economic crisis. The program modifications will expand flexibility for investors, mortgage servicers and originators to assist more people who owe more on their mortgage than their home is worth because their local markets saw large declines in home values.

These changes, in addition to changes to the Home Affordable Modification Program (HAMP), will help the Administration meet its goal of stabilizing housing markets by offering a second chance to up to three to four million struggling homeowners through the end of 2012. Costs will be shared between the private sector and the Federal Government; funding from the Troubled Asset Relief Program (TARP) will not exceed the $50 billion originally allocated for housing programs.

Housing Policy Overview

The Administration's goal is to promote stability for both the housing market and homeowners. To meet these objectives, the Administration has developed a comprehensive approach using state and local housing agency initiatives, tax credits for homebuyers, neighborhood stabilization and community development programs, mortgage modifications and refinancing, and support for Fannie Mae and Freddie Mac. With the record-low mortgage rates seen this past year and, thanks in large part to these programs, more than four million homeowners have refinanced their mortgages to more affordable levels helping to save more than $7 billion in the past year; more than one million are saving an average of around $500 per month through the Administration's mortgage modification program; home equity (wealth for homeowners) increased by more than $13,000 for the average homeowner in the last three quarters of 2009; and the economy is growing.

Even with this success, we continue to see challenges. Servicers were slow to implement HAMP, resulting in a slow start for the program. Recent improvements in the program have accelerated the pace of modifications. But our strategy to address the crisis must evolve because our challenges have also evolved. The enhancements announced on March 26, 2010 are responsive to the changing needs of homeowners across the country.

Our housing initiatives must balance the need to help responsible homeowners struggling to stay in their homes, with the recognition that we cannot and should not help everyone. The President has said: "We can't stop every foreclosure." And in fact, we can't maintain this balance if we try to assist every borrower. For example, investors and speculators should not be protected under our efforts, nor should Americans living in million dollar homes or defaulters on vacation homes. Some people simply will not be able to afford to stay in their homes because they bought more than they could afford. Instead, the Administration must focus on providing responsible homeowners opportunities to obtain a modification or to refinance and prevent avoidable foreclosures and, when necessary, facilitate the transition to a more sustainable housing situation. The newly announced adjustments are tailored to accomplish these goals by helping a targeted group of borrowers.

The new Federal Housing Administration (FHA) refinance option will provide more opportunities for lenders to restructure loans for some families who owe more than their home is worth. This should help to create stabilizing incentives in the housing market. This is a voluntary program for lenders. To be eligible for refinancing through FHA, borrowers must be current on their mortgage..

Eligible homeowners for the new FHA refinance option must, for example live in an owner-occupied principal residence and have a mortgage balance less than $729,750. As I will describe at greater length later in this testimony, their lenders must agree to write down the balance on their underwater loan to a sustainable level, and their new monthly mortgage payments must be affordable (not greater than 31 percent of their income). This new option, and the new flexibilities for HAMP program, will enable us to more effectively reach this target population.

Taken together, the Administration's broad housing initiatives and the newly announced flexibilities will offer a second chance to millions of responsible, middle-class American families struggling to stay in their homes and will help stabilize our households, neighborhoods and communities.

Background on Housing Program Initiatives to Date

The Administration has taken a broad set of actions to stabilize the housing market for the benefit of American homeowners. These efforts are having an impact on our housing markets – we are seeing signs of stabilization. Just over one year ago, stress in the financial system had severely reduced the supply of mortgage credit, limiting the ability of Americans to buy homes or refinance mortgages. Millions of responsible families who had made their monthly payments and fulfilled their obligations saw their property values fall, and found they were unable to refinance at lower mortgage rates.

In February 2009, less than one month after taking office, President Obama announced the *Homeowner Affordability and Stability Plan*. As part of this plan and through other initiatives, the following actions have been taken to strengthen the housing market:

Actions Supporting Market Stability and Access to Affordable Mortgage Credit

- The Administration has provided strong support to Fannie Mae and Freddie Mac to ensure continued access to affordable mortgage credit across the market;
- Together, Treasury and the Federal Reserve have purchased more than $1.4 trillion in agency mortgage backed securities, which helped keep mortgage rates at historic lows, allowing homeowners to access credit to purchase new homes and refinance into more affordable monthly payments; and
- The FHA and Ginnie Mae have played an important counter-cyclical role, providing liquidity for housing purchases and refinancing at a time when private lending has declined.

Actions Helping Homeowners Purchase Homes, Refinance and Modify Mortgages to More Affordable Payments, Prevent Foreclosures and Stabilize Communities

The Administration has:

- Launched a modification initiative to help homeowners reduce mortgage payments to affordable levels and to prevent avoidable foreclosures. Homeowners in active modifications are saving around $500 per month on average;
- Supported temporarily expanding the limits for loans guaranteed by Fannie Mae, Freddie Mac, and FHA from previous limits up to $625,500 per loan to $729,750 to provide needed support to keep markets functioning during this crisis;
- Expanded refinancing flexibilities for the Fannie Mae and Freddie Mac loans, particularly for borrowers with negative equity.
- Combined with historically low mortgage rates, this has helped more than four million American homeowners to refinance, saving an estimated $150 per month on average and more than $7 billion in the past year;
- Launched a $23.5 billion Housing Finance Agencies Initiative which is helping more than 90 state and local housing finance agencies (HFAs) across 49 states provide sustainable homeownership and rental resources for American families;
- Supported the First-Time Homebuyer Tax Credit, and the subsequent extension and expansion of the credit to also assist move-up buyers, which has helped hundreds of thousands of responsible Americans purchase homes;
- Through the Recovery Act, the Administration is providing over $5 billion in support for affordable rental housing through low-income housing tax credit programs and $2 billion in additional support for the Neighborhood Stabilization Program (NSP), on top of the

first round of $4 billion of NSP funds, to restore neighborhoods hardest-hit by concentrated foreclosures; and

- On February 19, 2010, the Administration announced the $1.5 billion HFA Hardest-Hit Fund for five state HFAs in the nation's hardest-hit housing markets to design innovative, locally targeted foreclosure prevention programs. On March 29, 2010, we announced a $600 million expansion of that program for an additional five HFAs.

HAMP has provided more than one million struggling homeowners a second chance to stay in their homes, with each homeowner in a modification saving around $500 per month on average. Often overlooked, an additional 650,000 families experiencing financial difficulty were assisted through FHA's variety of loss mitigation options since the beginning of FY 2009.

Together, these initiatives are having an impact – strengthening the housing market, helping responsible homeowners prevent avoidable foreclosures and rebuilding communities and neighborhoods. Today mortgage rates remain near historic lows – the primary interest rate is now about 5.20 percent. We are also seeing encouraging signs in housing indicators – home prices and the pace of home sales have stabilized in recent months.

The Challenge of Underwater Homeowners

An estimated 11 to 15 million mortgages, or approximately one-fourth of outstanding mortgages, are for amounts that exceed the value of the underlying home. However, it is important to put this number into context as this includes owner-occupied homes as well as mortgages on second homes and investment properties. While it is difficult to estimate the precise percentage of underwater mortgages that are on owner-occupied homes, it is important to note that the Administration's efforts are specifically targeted to assisting borrowers to remain in their primary residence. As stated earlier in this testimony and elsewhere, the President and the Administration has repeatedly said that we cannot and should not stop every foreclosure. The recently announced program enhancements to FHA and HAMP that we are discussing today are available only for mortgages on owner-occupied homes.

Many such homeowners now find themselves owing more on their home than its current market value. Many of these homeowners are underwater due to sharp price declines in their local housing markets due to no fault of their own – some happened to buy at the peak of the boom, while others have suffered from the impact of foreclosures on properties in their neighborhoods. In many cases, neighbors lost their jobs or suffered other types of financial distress, leading to resale at much lower prices, sharply lowering the market value of the other homes in the neighborhood. Underwater homeowners are often facing unaffordable monthly payments, putting them at an increased risk of default, which would lead to further destabilization of the housing market and the local economy. Facilitating principal writedowns for homeowners who are now in mortgages that place them dangerously close to default will enable them to restructure their debt, refinancing into more sustainable loans. By lowering their risk of default, these efforts will also improve prospects for their neighbors by lowering the likelihood that the local housing market will suffer from more foreclosures.

It is also important to note that the majority of underwater homeowners are still current on their mortgage. While many underwater borrowers are at imminent risk of foreclosure, the majority of underwater borrowers are still making their monthly mortgage payments. Of the 11 to 15 million mortgages that are estimated to be underwater, a far smaller number of families are at imminent risk of losing their homes to foreclosure. The Administration is keenly aware of the potential for moral hazard in principal reduction and has carefully designed the guidelines of the principal writedown enhancements to FHA and HAMP to discourage borrowers from purposefully becoming delinquent on their loan, otherwise known as strategically defaulting, solely to receive a principal writedown. To this end, borrowers are required to be current on their existing loan to be eligible to refinance into a FHA-insured mortgage.

FHA Refinance Option

To address the challenge of underwater homeowners, we have made adjustments to Federal Housing Administration (FHA) programs that will permit lenders to provide additional refinancing options to homeowners who owe more than their home is worth because of large falls in home prices in their local markets. These adjustments will provide more opportunities for qualifying mortgage loans to be responsibly restructured and refinanced into FHA loans as long as the borrower is current on the mortgage and the lender reduces the amount owed on the original loan by at least 10 percent.

The new FHA loan must have a balance less than the current value of the home, and total mortgage debt for the borrower after the refinancing, including both first and any other mortgages, cannot be greater than 115 percent of the current value of the home – giving homeowners a path to regain equity in their homes and an affordable monthly payment. By requiring a meaningful principal write-down in conjunction with the newly refinanced loan, borrowers will have a more sustainable loan that will be more affordable. Additionally, borrowers will have an opportunity to refinance into current interest rates, which remain low.

This refinancing will help homeowners by setting monthly payments at affordable levels and decreasing the mortgage burden for families owing significantly more than their homes are worth. Keeping more responsible families in their homes should support the continued recovery of the housing market.

Rationale for Expanded Efforts to Encourage Principal Writedowns

As the housing crisis has evolved, so have the challenges – negative equity is an important cause of foreclosures, along with affordability and unemployment. As such, facilitating principal writedowns by private investors and lenders is an additional tool that will be useful to stem the tide of foreclosures.

Many analysts have identified a strong correlation between loan-to-value ratios of homeowners and the likelihood that they will default. In many cases, providing a principal writedown to a borrower is more economically rational for an investor or lender than not doing so, as lenders lose significant value when a home goes to foreclosure. Many first-lien investors and analysts of loan defaults have shown that providing principal writedowns for loans that are more than 20% underwater significantly improves loan performance and reduces the potential for those loans to default. As a result, the cost of providing the principal writedown, which is borne by the private sector, is lower than the eventual loss if the loan were to default and the home go to foreclosure. The FHA refinance option provides a vehicle for many investors and lenders to reduce their expected losses while also providing responsible borrowers with meaningful debt relief and better enabling them to afford to remain in their home.

The FHA refinance option is voluntary and both homeowners and investors must agree to the transaction. Early in the housing crisis, principal writedowns were limited, due in part to uncertainty about where house prices would stabilize. Now that housing prices have been more stable for an extended period, lenders can make more accurate calculations about the expected returns from principal writedowns. In this new phase of recovering from the housing crisis, principal reduction should offer an important additional path to interest rate reductions or forbearance to effectively prevent foreclosure – even when the different approaches might result in the same monthly payment for the homeowner. In short, providing homeowners with a path to positive equity can be a very helpful factor to prevent loan defaults.

Options are Designed to Alleviate Obstacles to Market Coordination and Built To Leverage Existing Market Incentives and Mortgage Finance Infrastructure

The vast majority of the burden of writing down these loans will fall where it belongs, on the lenders and investors, not on the taxpayer. As mentioned earlier, the private sector has increasingly recognized that a principal writedown can be an economically rational alternative to a foreclosure to preserve value in their mortgage holdings. The adjustments to the FHA refinance program and HAMP support the efforts already underway in the market and offer incentives to expand their reach to loans in which the servicer of the loan may differ from the investor and to overcome obstacles to market coordination, including the presence of a second lien and stresses on the capacity of servicers to perform modifications.

Second Liens

It is estimated that approximately half of underwater homeowners have a second lien in addition to their primary mortgage, contributing to the total amount of mortgage debt on the home (their combined loan-to-value, or CLTV). Some second lien holders have been willing to write-down a portion of their lien in exchange for the increased security of a lower-risk refinance. But many second lien holders have not been willing to do so, and as a result the existence of a second lien has effectively prevented principal writedown transactions, even when the first lien holder has been willing to do so. Relatedly, many first lien holders have been unwilling to offer principal writedowns to borrowers unless the second lien holder has been willing to do so as well. This has resulted in many homeowners not receiving offers of principal writedowns simply due to this lack of coordination, even when it is the economic best interest of all parties involved. If this coordination problem could be resolved, both first and second lien holders would have less risky investments due to increased borrower equity and the borrower would benefit from lower monthly payments and greater economic security.

To address this challenge, both the FHA refinance option and the enhancements to HAMP include incentives payments ranging from 10 cents to 21 cents on the dollar, depending on the borrower’s loan-to-value, to encourage the extinguishment of second liens. These incentives will be paid through TARP funds allocated to supporting the housing recovery. In the particular case of the FHA refinance option, while the new FHA-insured first lien after principal writedown cannot exceed 97.75% of the current value of the home, FHA permits a combined maximum loan-to-value of 115% to enable borrowers to still benefit from a principal writedown offered by their first lien holder so long as any other lien does not take the combined loan-to-value of all mortgage debt above 115% of the home's current value.

The Administration welcomes and supports the leadership of the House Financial Services Committee in evaluating the scope of this challenge, including yesterday's hearing on "Second Liens and Other Barriers to Principal Reduction as an Effective Foreclosure Mitigation Program" as we work to better assist homeowners.

Stress on Servicers and Excess Capacity of Originators
Refinancing into a new FHA-insured first mortgage requires a borrower to originate a new mortgage that complies with FHA's underwriting criteria. This approach relies primarily on loan originators as opposed to servicers. We believe that the nationwide system of FHA mortgage originators will provide much greater capacity to process applications than homeowners experienced with previous efforts that relied exclusively on loan servicers.

As we have seen with the initial startup of HAMP, many servicers were overwhelmed and ill-equipped to respond to the volume of homeowners needing assistance. While the complexity of the programs challenged the capacity of servicers, it is also true that many institutions were slow to make the investments in systems and staff needed to process applications. We are encouraged that most servicers have begun to correct this problem to better facilitate HAMP modifications. Nonetheless, many lenders are still experiencing a significant strain on their capacity to address the needs of borrowers through their servicing operations, while they retain excess capacity in their mortgage origination operations. The structure of the FHA refinance option is thus intended to more effectively utilize the resources available in the existing infrastructure of the mortgage finance system.

Expanding the Reach of Principal Writedowns Offered by the Private Sector
As mentioned earlier, as housing prices have stabilized, servicers have been more willing to offer principal writedowns on whole loans owned by the lender. On March 24th, Bank of America announced a new initiative to offer principal writedowns to borrowers who took out complicated mortgage products (subprime, Pay Option ARM, prime 2-year hybrid ARM), and where the loan is already eligible for HAMP. Other banks have selectively reduced balances on certain loans, including Wells Fargo, who reported that it modified loans for 52,600 borrowers with "option-ARM" loans last year, totaling $2.6 billion in principal write-downs.

We are encouraged that lenders are increasingly offering mortgage relief through principal writedowns for struggling borrowers. Their initiatives reinforce the Administration's broader efforts to provide relief to homeowners and are consistent with our housing policy to prevent avoidable foreclosures of owner-occupied homes. We encourage banks to move forward with programs aimed at providing more affordable and sustainable mortgages for homeowners.

In addition to Bank of America and Wells Fargo, Citibank, and J.P. Morgan Chase – the four largest mortgage-holders and servicers – as well as other lenders, have expressed support for the Administration's efforts to assist homeowners and have indicated that they are in the process of evaluating a larger portfolio of underwater borrowers for principal writedowns through the FHA refinance option and enhanced HAMP modification efforts. The program adjustments to FHA and HAMP to facilitate principal writedowns are available to all participating mortgage servicers.

It is also encouraging to see that major mortgage investors have expressed support for these housing programs. Following the announcement of the Administration's expanded housing efforts, the Association of Mortgage Investors stated that "the Association of Mortgage Investors supports the program announced by the Obama Administration to provide a path for reduced principal through a refinancing program for homeowners who are 'underwater' on their mortgage. The Association commends the officials at the Treasury, HUD, FHA and the White House for their efforts to develop this program. Investors have long felt that the only way to provide homeowners long term relief is to address the problem of both affordability and negative equity. This is not only important for the homeowner, but also critical to the housing market and the economy as a whole."

Borrower Eligibility and Selection by Lenders or Investors for a FHA Refinance

To qualify for a FHA refinance, the borrower must meet FHA underwriting requirements: the new first loan must be no greater than 97.75% of the current value of the home; borrowers must be current on their loan; and FHA underwriting requirements must be met through full documentation. Additionally, there must be a minimum principal writedown by the mortgage holder of at least 10 percent of the unpaid balance of the original loan, and the combined mortgage debt must be written down to a maximum of 115 percent of the current value of the home.

It is worth noting that FHA's standard underwriting criteria includes all mortgage debt (first liens and any second or other mortgage debt) in front-end qualifying ratios, which means that borrowers who qualify will receive a new loan that is much more sustainable, as the total monthly mortgage payment, including all mortgage debt, will not be greater than approximately 31 percent of income, and total debt service including all forms of household debt will not be greater than approximately 50 percent, except for some borrowers with especially strong credit histories.

Homeowners must be current on their existing mortgage payment, occupy the home as their primary residence, and fully document their income. As with any loan forgiveness, the short refinancing should be reflected on borrowers' credit score.

Expected Loan Performance and Impact to FHA's Capital Reserves

The new loan must conform to FHA's underwriting requirements, so performance would likely fall within acceptable risk thresholds for FHA. That being said, there is reasonable concern that there may be a performance differential – these loans may perform worse than refinanced loans that were not previously underwater. As such, loans that conform to all guidelines of the FHA refinance option will be counted separately towards lender performance monitoring through Credit Watch- the system by which FHA suspends or terminates lenders for high default rates. Originating these loans will not hinder a servicer's ability to pursue other lines of business, mitigating a potential barrier to servicers' and investors' willingness to offer principal writedowns to borrowers.

Of the $14 billion of TARP funds allocated to support the FHA refinance option, a portion will be made available to provide coverage to lenders for a share of potential losses on these loans, mitigating detrimental impacts to FHA's capital reserve as a result of facilitating the private sector to provide principal writedowns to underwater borrowers in conjunction with these refinancings. No TARP funds will go to the FHA itself for any loans.

Additional Incentives for Servicers to Modify Loans Already Insured by FHA
HAMP has also been expanded to provide incentives for servicers to modify FHA-insured loans. This program was initially developed last July by FHA and became effective August 15, 2009. With the issuance of new rules on March 26 (Supplemental Directive 10-03), TARP-funded pay-for-success incentives will be available to borrowers and servicers whose loans are modified under the FHA-HAMP guidelines. These incentives improve the quality of this modification option for borrowers and offer a path toward some principal relief. FHA-HAMP incentives are retroactive for all corresponding modifications already offered and therefore we expect the first pay-for-success incentive payments to be paid as early as September 2010.

Additional Assistance for Underwater Homeowners through HAMP Revisions
The FHA Refinance option is part of the broader set of policy adjustments announced on March 26th. This also included revisions to HAMP that will require servicers to consider an alternative modification approach that helps borrowers achieve principal relief over time through earned forgiveness of principal that is forborne in the initial loan modification. For HAMP-eligible borrowers that owe more than 115 percent of the current value of their home, servicers will be required to run the standard Net Present Value (NPV) test and an alternative NPV test that includes incentives for each dollar of principal write-down. If NPV under the alternative approach compares favorably to the result under the standard approach, the servicer will have the option to use it. In this way, servicers are able to demonstrate to investors that using principal write-down likely results in a higher yielding modification.

Conclusion

As mentioned before, while we have enhanced our foreclosure prevention programs through these refinements to FHA and HAMP programs, the Administration believes that the role of government should be appropriately limited to assisting homeowners to remain in their primary residence. That being said, we acknowledge that there will be circumstances where particular borrowers will not be able to remain in their home. In such cases, we have also developed initiatives to help homeowners make the transition to more affordable housing by providing incentives to encourage servicers and investors to make wider use of short sales and deeds-in-lieu.

In the wake of the housing crisis, FHA and Ginnie Mae have played an important countercyclical role to ensure liquidity in the mortgage finance system, including an increased role in supporting mortgage originations, refinances, and foreclosure prevention. Additionally, HAMP is the largest mortgage modification program our nation has seen, in size, scope and impact. In addition to the relief it provides directly, it has impacted the broader industry by forcing mortgage servicers to build up systems to meet unprecedented demand and streamlining and standardizing modification processes across the industry. While significant progress has been made in the first year of program implementation, the enhancements announced on March 26 demonstrate this Administration's capacity to apply lessons learned, strengthen program implementation and broaden the program's impact.

The Administration remains committed to the many other housing market stabilization efforts that work in concert with HAMP and FHA, including substantial support for the housing markets through support of Fannie Mae and Freddie Mac to stabilize those institutions and help ensure that affordable mortgage credit is available; refinancing opportunities that have allowed more than four million borrowers to refinance; an initiative to provide support and financing to state and local housing finance agencies which in turn provide tens of thousands of affordable mortgages to first-time homebuyers and help develop tens of thousands of affordable rental units for working families, including those displaced by the housing crisis and foreclosures.

The Administration is on track to meet the stated goals of offering a second chance to 3 to 4 million homeowners and – most importantly – to help prevent avoidable foreclosures for as many deserving American families as possible.

Substantial progress has been made but the Administration recognizes that real and complex challenges to achieving these important goals still exist. We will continue to assess the Administration's ability to meet these challenges and contribute to the stability of housing markets.