STATEMENT OF

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COMMITTEE ON FINANCIAL SERVICES

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Chairman Frank, Ranking Member Bachus, and members of the Committee, I appreciate the opportunity to testify today concerning the draft FHA Housing Stabilization and Homeownership Retention Act of 2008 (Act). Today's hearing takes place in the context of broad efforts by the government, the industry, and community organizations to respond to challenges presented by rising rates of foreclosure.

The Act would establish a new program that would provide a distressed borrower who could no longer afford his or her mortgage, and the holder of the mortgage, with an alternative to the costly prospect of foreclosure. This program has three key elements: first, 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; second, the mortgage holder would accept the corresponding loss; and third, the mortgage would then be refinanced into a new FHA-insured mortgage product at the lower amount. The concept 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.

Because the program is voluntary, the Act could be a useful new tool, and safety and soundness considerations should be manageable. Each bank or mortgage holder could evaluate the range of risks and benefits of the new program relevant to its particular situation. If the option proved to be an attractive and less costly alternative to foreclosure as intended, it could save national banks significant amounts of time and money, and benefit their borrowers and their communities.

The pivotal question is the extent to which borrowers and mortgage holders would actually choose this new voluntary option. This will depend on a potentially complex mix of factors. On one hand, the direct cost of foreclosure is steep in most cases, with lenders' and investors' losses on foreclosure typically in the range of 40 percent, although this number can vary. On the other hand, depending on particular circumstances, such as the amount of home price decline and the borrower's documented income, the direct cost from exercising the refinancing option of the new program may also be steep. We include a number of specific examples in our written statement to show that in some very plausible circumstances, exercising that option may or may not be less costly than foreclosure.

Another variable is the extent of "payment shock" faced by some borrowers with adjustable rate mortgages or "ARMs." Initial fixed interest rates on hybrid ARMs "reset" to higher variable rates, but these rates have recently declined, as key ARM interest reference rates dropped sharply this year. Thus, more ARMs may be affordable than previously envisioned, so long as interest rates remain low.

Nevertheless, recent property value declines have left many borrowers owing more than their houses are worth, sometimes referred to as "negative equity." Foreclosures are still up, and it appears that negative equity is contributing significantly to that problem.

Where second mortgage holders are present, refinancing under the new program faces additional challenges. As I explain in my written testimony, when a borrower has insufficient equity in his or her home to cover first and second mortgages, the second mortgage holder's objectives and incentives are very different from the first's. This suggests that it will be essential to understand the concerns that second mortgage holders have and to identify incentives they regard as workable. The existence of private mortgage insurance further complicates matters.

In conclusion, I would note that designing incentives that balance the needs of borrowers, lenders, and investors is a very complex and delicate task. There is no easy solution, and we have made suggestions in our written statement to address some of the issues we have identified. At the end of the day, the more constructive the options that stakeholders have to address the prospect of foreclosure, the greater the chances that homeowners can remain in their homes.