Embargoed until
April 9, 2008, at 10:00 am

Statement of

John M. Reich
Director, Office of Thrift Supervision

regarding

Using FHA for Housing Stabilization and Homeownership Retention

before the

Committee on Financial Services
United States House of Representatives

April 9, 2008

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STATEMENT OF JOHN M. REICH
DIRECTOR, OFFICE OF THRIFT SUPERVISION
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I. Introduction

Good morning, Chairman Frank, Ranking Member Bachus and members of the Committee. Thank you for inviting me to testify on how to turn back the rising tide of home foreclosures in America and particularly on the views of the Office of Thrift Supervision on the FHA Housing Stabilization and Homeownership Retention Act of 2008. I'd like to commend you for your diligence and leadership on this important subject. I'd also like to thank you for the cooperative approach and exchange of ideas that my staff has had with yours as we and others work toward this essential common goal.

In my testimony today, I will first address how changes in the underlying housing market are having an impact on thrift lenders. Key measures of financial health – including earnings and profitability, loan loss provisions and net charge offs, and loan performance – have been affected by the downturn in the housing economy over the past year. While industry capital remains strong and asset quality is relatively stable, we are maintaining a watchful eye on loan performance and industry exposure to the fallout from problems in the subprime mortgage market. We are also closely monitoring thrift industry exposure to upcoming resets on prime pay-option adjustable rate mortgages (ARMs) that are expected to occur in the next several years.

While a generally favorable interest rate environment continues, the thrift industry's high levels of earnings and profitability from several years of mortgage originations and sales has abated. Although thrift earnings have been challenged in recent quarters, industry capitalization has remained strong due, in part, to good stewardship by thrift managers, who have taken steps to address this challenging business environment.

This is an important backdrop for our discussion because a strong and vibrant thrift industry, supervised by a regulator with experience and specialized expertise in mortgage markets and mortgage finance, must be an integral part of any plan to preserve

homeownership, prevent unnecessary foreclosures, and address other problems that may be caused by the inevitable periodic fluctuations in the housing and mortgage markets.

I will also discuss the FHA Housing Stabilization and Homeownership Retention Act of 2008, as well as the OTS Foreclosure Prevention Proposal. Both seek to preserve homeownership and limit preventable foreclosures through the use of FHA loan programs. Our continuing work in developing and fine-tuning the OTS Foreclosure Prevention Proposal has included extensive conversations with mortgage market participants and stakeholders, and allowed us to identify and study the issues involved. In this process, we have gained key insights into the incentives that drive the behavior of these mortgage market participants--incentives that present both obstacles and opportunities that must be considered in fashioning an appropriate strategy for addressing the challenge that we face.

II. State of the OTS-Regulated Thrift Industry

A. Thrift Industry Data/Numbers

1. Overview

The OTS-regulated thrift industry comprises a diverse group of institutions that range from small one-office depositories to large and complex institutions that operate on a nationwide basis. As of December 31, 2007, OTS supervised 826 thrift institutions with combined assets of $1.51 trillion. Of these institutions, 39 percent were held in the mutual form of ownership, the historical form of thrift ownership, and 61 percent were stock held depositories. Virtually all stock held institutions operate within some form of a holding company structure.

The majority of OTS-regulated thrifts are full-service, community-based financial institutions offering a wide range of products to consumers and small- to medium-sized businesses. Although most thrift institutions use the charter to specialize in retail mortgage and consumer lending activities, some institutions have a more narrowly focused business strategy. These other operating strategies typically involve a market niche or more narrowly focused business model such as a trust-only charter, a credit card lending focus, or mortgage banking operations.

While there is some diversification with the use of the thrift charter, savings and loan holding companies (SLHCs) are even more diverse. SLHCs are involved in a wide range of businesses and activities, and range in size from small shell holding companies to large international conglomerates. While the predominant characteristic of most SLHC activities involves financial services, there are a number of SLHCs that conduct

operations in numerous non-financial activities, including manufacturing, industrial and retail operations. Among the larger and more complex companies that own thrifts are investment banking firms, insurance companies, and diversified financial services firms with international scope.

As of December 31, 2007, the OTS supervised 475 SLHC structures – including 109 mutual holding company structures – with aggregate consolidated assets of approximately $8.5 trillion.

2. Industry Performance

The profitability of mortgage market participants was especially hard-hit in 2007 and this had a significant impact on overall thrift profitability for the year. The OTS-regulated thrift industry posted profits of $2.9 billion for 2007, down from $15.8 billion in 2006. The industry's return on average assets was 0.19 percent for 2007, compared with 1.06 percent for 2006.

Of particular note, the industry recorded a loss of $5.2 billion in the fourth quarter of 2007, a record in terms of dollars, which equated to a 1.38 percent return on average assets for the quarter. While goodwill write-downs of approximately $4 billion by a handful of institutions and a $2.2 billion restructuring charge by one institution were significant components of the aggregate industry loss for the quarter, record levels of loan loss provisioning also played prominently in fourth quarter industry performance.

While nationwide home sales slowed throughout 2007, thrift industry mortgage originations (including 1-4 family and multifamily lending) rose for the year. Total industry mortgage originations were $716.1 billion in 2007, up 12 percent from $642.2 billion in 2006. While total industry originations of $166.6 billion in the fourth quarter were down from $185.7 billion in the third quarter of 2007, the fourth quarter of 2007 was still significantly higher than the $134.3 billion of industry originations in the fourth quarter of 2006.

Thrifts continue to account for a sizable portion of the U.S. residential mortgage market, originating 31 percent of total 1-4 family loans in the fourth quarter of 2007. An estimated 9 percent of thrift mortgage originations were ARMs in the fourth quarter of 2007, down from 13 percent in the third quarter of 2007 and from 12 percent of all thrift originations in the fourth quarter of 2006.

Thrifts currently hold approximately two-thirds of their assets in mortgages and mortgage related instruments. As of December 31, 2007, one-to-four family mortgage loans constituted 48.9 percent of industry assets (including 7.5 percent of assets in home equity lines of credit); 4.1 percent of industry assets were in multifamily loans and 13.7 percent of industry assets were in other mortgage related instruments. Of total

outstanding one-to-four family mortgages and mortgage related instruments held by the industry, approximately 61.2 percent were ARMs.

With the impact of a weak housing market on thrift balance sheets, institutions are taking appropriate steps to protect their operations. Thrift regulatory capital measures also remain strong. As of the end of 2007, 98.5 percent of all thrifts – holding 99.8 percent of industry assets – exceeded the "well-capitalized" regulatory standards. Regulatory capital measures exclude goodwill, so these measures were unaffected by the large goodwill write-downs taken in the fourth quarter. In addition, thrifts continue to add to their loan loss provisions, which increased to 0.75 percent of average assets for the year from 0.25 percent in 2006. The additions to loan loss provisions reflect the increase in non-current loans as a result of the deteriorating performance of loans originated in the past several years.

B. Market Conditions and Challenges

1. The Current Housing Economy

The slump in the housing market continues to adversely impact loan production and performance. Non-conforming loan[1] originations fell 49 percent in the fourth quarter, as the secondary market for bonds backed by the collateral remained shuttered. According to data collected by Inside Mortgage Finance, only $84.5 billion of non-conforming loans were originated in the quarter ended December 2007, representing just 19.9 percent of total loan production. This was well below the peak origination period of 2005, when the total reached $1.58 trillion or 50.4 percent of all production. Production of jumbo loans fell 47 percent to $44.0 billion, or less than 10 percent of all originations, while Alt-A and subprime production volume plummeted to $27.0 billion and $13.5 billion respectively. In contrast, FHA/VA loan production rose steadily in 2007 from a low of $19.0 billion in the first quarter to $31.0 billion at the end of the year.

Home construction also impacts the performance of thrifts, and activity continues to trend downward. Housing starts for both single- and multi-family dwellings in February were down 28.4 percent from a year earlier and more significantly, were 33.2 percent lower in the last three months. The annual production of single-family homes fell to its lowest level since 1991 at 707,000 units.

According to the U.S. Department of Commerce, purchases of new homes -- often a leading indicator of housing conditions -- fell to a 13-year low of 590,000 (annualized) units in February. This was a 29.8 percent decline in sales from a year earlier and was the worst sales decline since record-keeping began in 1963. The number of new homes

[1] Non-conforming loans are defined as jumbo, subprime, and Alt-A loans for purposes of this document.

for sale fell to 471,000 in February, but given the current sales pace, it would take 9.8 months to sell these homes -- the highest number of months since October 1981.

In February 2008, sales of existing homes, which account for 85 percent of all home sales in the U.S., fell 24 percent from a year go to 5.03 million units, the largest yearly slump in more than a decade. According to the National Association of Realtors, the inventory of existing homes available for sale stands at 9.6 months (assuming the February sales pace), less than the 10.3 months in January, but near the peak levels reached in October 2007. The median sales price of an existing single-family home fell 8.2 percent on a year-over-year basis in February.

Mortgage loan performance also deteriorated in January 2008, as reported by LoanPerformance.[2] The national delinquency rate for prime loans climbed to 3.45 percent, nearly a percentage point higher than a year earlier. The most significant increase in late payments was exhibited by subprime borrowers, with both fixed rate and ARM loans, where the pace rose to 21.31 percent, more than 7 percent greater than in January 2007. Foreclosure rates also climbed higher in all loan categories, with the greatest gain among Alt-A and subprime homeowners.

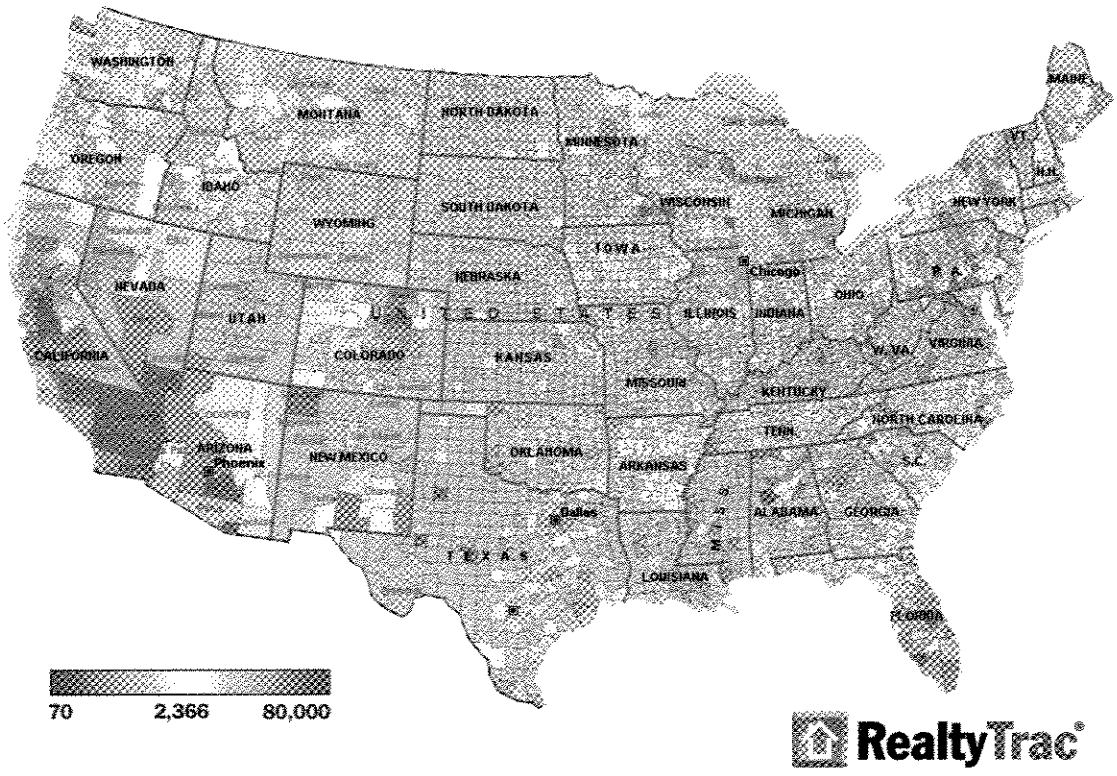
2. The Mortgage Markets

Home prices, as reported by the S&P/CaseShiller Home Price Index (HPI), continue to weaken. The January 2008 HPI for 20 U.S. cities showed a 10.7 percent annual decline in home prices, the thirteenth consecutive month the index has fallen. Nineteen of the 20 metropolitan areas in the index reported annual price declines, with Charlotte the only city to report a gain. Sixteen of the metropolitan areas reported record price declines, with Las Vegas and Miami sharing the top spot for the largest annual decline, 19.3 percent, in home prices during the month. The impact of falling home prices may eventually improve the pace of home sales, but may also exacerbate the number of mortgage defaults. Coupled with the fact that many mortgages in recent years have been issued with "simultaneous seconds" (i.e., second mortgages issued to borrowers in lieu of the imposition of private mortgage insurance), many mortgages currently have high loan-to-value (LTV) ratios on the combined first and second mortgages.

The combination of high LTV ratios and the decline in home prices is forcing many mortgages "underwater," - a situation in which the borrower owes more than the home is worth. This has had a dramatic effect on increased foreclosure rates. As evidenced in the following chart from RealtyTrac.com, higher foreclosures rates are no longer isolated to the previously "hot" real estate markets, but are now evident in many areas of the country.

[2] LoanPerformance is a subsidiary of First American Real Estate Solutions.

Households per Foreclosure Action – February 2008



The bulk of 2/28 and 3/27 ARMs originated in 2005 have experienced their first rate reset. However, the FDIC has estimated that there are 1.3 million loans scheduled for rate resets in 2008, and there are many prime option ARMs approaching their first rate reset, which has the potential to produce further increases in mortgage loan delinquencies.

While there are different projections and estimates of the impact of rate resets on an already volatile housing market, we know that neither subprime nor option ARM rate resets have peaked. Coupled with the possibility that many resetting loans may already be underwater, upcoming rate resets pose serious challenges, and potential opportunities, for thrift mortgage lenders. Now is the time to identify creative approaches to addressing these problems. And it is my intention that the OTS and the thrift industry play an important role in ensuring the continued viability, sustainability, and affordability of the U.S. housing markets.

III. Foreclosure Prevention and Loss Mitigation Efforts

A. Overview of Affected Parties/Participants

In exploring foreclosure prevention solutions, it is important to understand the interests of the various participants when a mortgage loan is made and, in many cases, subsequently securitized.

The first group of affected participants is the borrowers. Even within this group, however, there is not a single borrower profile. This, of course, complicates appropriate responses and solutions aimed at assisting borrowers on a blanket or wide-scale basis. Generally, distressed borrowers can be sub-grouped into three broad classes:

- Borrowers not able to sustain the financial demands of homeownership;
- Borrowers who can be helped, and who were put into their current situation because they were victims of predatory lending, poor loan advice, or poor judgment on their own part; and
- Borrowers who can be helped, and were put into their current situation because of a change in their personal circumstances and now require payment flexibility to get back on their feet.

The next group of participants in the process is lenders. Within this group, there are generally two sub-groups: portfolio lenders and lenders who originated for sale into the secondary market. It is relatively straightforward to understand the interests of a portfolio lender that retains the credit risk associated with originating a mortgage. Lenders that originated for sale and expected to transfer credit risk may not have been as prudent in underwriting and assessing the ability of borrowers to repay.

The next group of participants is investors in the securitization. A typical securitization has a number of different investor types with differing risk profiles, return expectations, and interests in the securitization. For example, the investors in the highest rated tranches have agreed to take a lesser return and assume a lower risk profile in exchange for a more stable and predictable income stream. Next, the typical securitization will have mezzanine tranches held by investors who have a more elevated risk profile than the AAA (highest rated) investors, but who also expect a certain return on their investment in the securitization. Finally, there are the residual owners or investors, who bought into the deal with the understanding that they had the potential for significantly higher returns if the securitization performed as expected, but would take the first losses if the securitization did not perform as expected.

Next, we have the interests of the securitizers, as well as the trustee of the trust established to hold the mortgages pursuant to the securitization. While the interests of these two groups are not clearly aligned, both attempt to ensure that the best interests of the investors are served. While the trustee pursues this agenda with the understanding that it has a fiduciary duty to the investors, it is sometimes confusing to figure out exactly how this fiduciary duty may be served in protecting the interests of different types of investors in the securitization. In contrast, the securitizer will typically attempt to make sure that a securitization remains intact to avoid litigation exposure and potential tax and accounting issues arising from its initial actions in establishing the securitization.

Finally, perhaps the most complicated and complex interest in a securitization is that of the servicer, whose goal is to make sure the mortgage loans perform and payments are made to the mortgage trust based on the timetable established in the securitization. In effect, the servicer is the bill collector for the securitization. In this regard, the role of the servicer is critical to the success and continued viability of a securitization. For the same reason, the servicer also figures prominently in any efforts to prevent foreclosures of mortgage loans held by the trust, including loan modification and loss mitigation efforts to keep borrowers in their homes. Providing proper financial incentives and/or aligning the interests of the servicer with the other parties in a securitization is, we believe, key to the success of any foreclosure prevention or loss mitigation program.

B. Loan Modifications and Workouts

1. Supervisory expectations and available data

The OTS has consistently encouraged regulated institutions to work constructively with borrowers whose mortgage loans are in default or for which default is reasonably foreseeable. We continue to stress that prudent workout arrangements, conducted in accordance with safe and sound lending practices, are generally in the long-term best interest of both borrowers and lending institutions.

As part of our ongoing efforts, we recently held a national telephone conference with our examiners concerning supervisory expectations for troubled debt restructurings by our institutions. Pursuant to effective credit risk management procedures, institutions should work with borrowers to alter repayment terms, reduce interest rates, forgive principal, or take any other steps appropriate to protect the borrower and the institution. When modifying or restructuring existing credits, it is incumbent on an institution and our examiners to ensure that restructured loans are properly identified, risk rated, accounted for, and reported to preserve the accuracy and integrity of financial statements. Loan modifications that are not properly accounted for will have the effect of masking delinquency and nonaccrual levels, which could lead to inaccurate loss reporting and allowances for loss calculations. While proper accounting for a troubled debt

restructuring will have an impact on an institution's bottom line, it can be a significantly less costly alternative to foreclosure.

Many mortgages are held in securitization trusts that have outside servicers to manage the cashflows arising from the underlying mortgages. Most loan servicing agreements have been structured under the assumption that loan modifications are rare and would be pursued on a case-by-case basis. Generally, delinquent loans can be modified under this approach if the borrower demonstrates a willingness and ability to repay the loan under modified terms and it is in the best interest of the investors to modify the loan rather than foreclose. However, a loan-by-loan evaluation is very time consuming. With the rate of delinquencies in the mortgage market and the impending payment resets of various ARM products, there is little time for this type of in-depth loan-by-loan analysis. There have been a number of initiatives proposed to address this problem.

To date, there has been support for private sector initiatives to develop and implement a streamlined plan, such as articulated in the American Securitization Forum's December 2007 statement of principles on this issue and the efforts of the HOPE NOW alliance, a private sector group comprising about 84 percent of subprime lenders. HOPE NOW programs include a streamlined approach that would allow approximately 1.2 million subprime borrowers to be fast-tracked into affordable refinanced or modified mortgages.

Eighteen participating HOPE NOW loan servicers, covering almost two-thirds of the industry, provided loan modification data in January 2008. HOPE NOW reports that for July 1, 2007 through January 31, 2008, these participants completed over one million loan workouts—including almost 650,000 for subprime borrowers. About three quarters of the workouts were repayment plans, and one quarter were loan modifications. The number of loan workouts during that period was nearly three times the number of completed foreclosure sales.

Building on the HOPE NOW Alliance reporting template, OTS has begun the process of collecting extensive loan level data from its six largest mortgage servicers, who collectively service more than $2.5 trillion in first lien mortgages, on their loan modification efforts. With this data, we will be able to assess the progress being made in this area, as well as the relative success over time of different loan modification strategies.

2. Issues and Obstacles

While private sector programs are the lynchpin to the success of troubled debt restructurings, there are also important roles for policymakers, consumer advocates, academics, and individual borrowers. Engaging all of these parties, along with industry

players, is the key to resolving troubled mortgage loans. It is with this in mind that the OTS proposed its foreclosure prevention plan, discussed below, on ways to prevent avoidable foreclosures of underwater mortgage loans.

Initial data suggest that loan modifications are more difficult to accomplish than we might have wished. For example, HUD recently reported that more than 116,000 loans have closed under the FHASecure program since it was launched in September 2007. However, only a small number of these FHASecure loans (1,500 of them as of March 9th) were made to refinance delinquent conventional loans. Thus, so far, FHASecure has not contributed significantly to putting distressed homeowners into mortgages they can afford. One of the most important considerations in structuring a viable loan modification program is reaching as many borrowers as possible, as quickly as possible. In our view, this translates into conducting an expeditious and systematic review of outstanding loans approaching reset -- or for which a rate reset has already occurred -- to identify broad categories of borrowers eligible for loan modifications. As simple as this concept sounds, in application it has many challenges. I believe it is critical in this effort to provide servicers with as much guidance and flexibility as practical to conduct meaningful reviews to identify borrowers in need of assistance.

In structuring a viable loan modification program, three goals should be recognized and incorporated. First, and most fundamental, the program should preserve and sustain homeownership. Second, of course, the program should protect homeowners from avoidable foreclosures due to interest rate resets. Finally, it is extremely important that the program be structured to preserve and maintain market integrity, as well as ensure the continued safety and soundness of depository institutions and the broader financial services industry.

Currently, about 1.3 million American families have subprime 2/28 and 3/27 mortgages that are scheduled to reset by the end of 2008. The initial "starter rate" for these loans typically ranged from 7 percent to 9 percent. About 30 percent of delinquent 2/28 and 3/27 loans were past due before the rate reset. Between 1980 and 2000, the national foreclosure rate was below 0.5 percent of aggregate mortgage loans. As recently as 2005, the national foreclosure rate stood at 0.38 percent. Since then, the foreclosure rate has risen 55 percent to almost 0.6 percent of outstanding mortgage loans. Far more troubling is that, among subprime borrowers holding a 2/28 or 3/27 loan product, foreclosures are projected to continue to rise.

There are several important factors in structuring a viable loan modification program that could lower these projections. First, as I noted at the outset, expediency is critical. Servicers should quickly review their loan portfolios to identify characteristics of groups of borrowers eligible for loan modifications. Eligibility standards will determine the likelihood of achieving meaningful impact under a loan modification program. Generally, borrowers should be eligible if, due to rate resets, they are either in default, or there is a reasonable foreseeability of default.

A program's success will also hinge on providing adequate time for troubled borrowers to work out of their current economic problems. We believe servicers should be prepared to extend the starter rate for five years. And it may also make sense to include a trial period, such as six months, for certain borrowers to be able to demonstrate that they can continue to pay under the starter rate before the starter rate is locked in under a loan modification. Generally, a trial period will serve to protect the interests of the lenders, avoid including in a modification program loans that are destined to fail, and provide resolution to borrowers rather than delaying the inevitable.

We are aware of a number of loan modification programs that have already been established. While these programs generally have been in place for short periods of time, i.e., several months, it is our understanding that strategies similar to those articulated above have been successfully deployed to modify significant numbers and dollar amounts of subprime 2/28 and 3/27 loans held in securitizations. For example, several programs have employed broad-based borrower identification criteria to identify groups or classes of loans at risk, and then applied established eligibility requirements to hone in on individual loans and borrowers at risk of default. Other programs have opted for more individualized fixes by identifying borrowers and re-underwriting with full documentation for a 30 year term. We support all of these programs and efforts to address the problem and encourage any standards or guidelines that provide maximum flexibility to servicers and lenders to address troubled subprime loans in a manner that protects both the borrowers and the underlying economic interests of investors.

It is also critical that our actions preserve the integrity of the broader mortgage markets, including capital market participation in the continued funding of the mortgage markets. While some have suggested that previous actions of the capital markets fueled speculative and unsafe mortgage lending activities, there remain many U.S. consumers who are homeowners solely because of favorable mortgage rates and terms that they received as a result of the efficiency of the U.S. capital markets. We must take great care that our efforts on behalf of some consumers who entered into bad deals do not compromise the greater, collective interests of all consumers. It would be a policy failure to produce a result that alters mortgage funding so that the future cost or availability of mortgage credit is adversely affected for all U.S. consumers.

We are currently at what can best be described as a crossroads in addressing the combined effects of reduced home prices and the next wave of rate resets for subprime 2/28 and 3/27 mortgage loans. Despite a decline in interest rates, foreclosures among subprime borrowers holding these types of mortgages are expected to rise. There are a number of programs that have been reasonably successful in structuring viable loan modification approaches, but more needs to be done -- and soon.

As recently reported, there have been significant industry efforts to structure guidelines for viable loan modification programs that can be implemented quickly, efficiently and effectively in the marketplace. Our understanding is that many of the

issues previously identified as significant obstacles to broad-scale loan modifications may, in fact, be issues that can be addressed within the terms of the pooling and servicing agreements that dictate the rights of servicers and impact on investors under terms of the trusts that hold the securitized assets. Given this, we believe legislative and/or regulatory actions that are not carefully crafted could hinder rather than help at this point in the process. Therefore, we continue to encourage the industry to identify and implement solutions that work, with the full understanding that legislative intervention may occur if it becomes clear that any proposed solution(s) will not be effective.

IV. Further Foreclosure Prevention Initiatives

In addition to providing relief to distressed borrowers and avoiding potentially significant losses to security holders, foreclosure prevention is attractive to the broader economy because of the stabilizing effect it could have on the housing markets. There are numerous challenges and considerations in formulating viable foreclosure prevention initiatives that have sufficient reach to provide relief to distressed borrowers, as well as a meaningful impact on the existing housing economy. These include:

- Who is covered (e.g., distressed borrowers in owner-occupied properties)?
- Is the plan appropriately calibrated to assist borrowers unable to pay rather than those unwilling to pay (and should a plan address the latter issue)?
- Will the plan prevent foreclosures, rather than forestall eventual foreclosures?
- Should there be a different foreclosure prevention approach for loans held in securitizations versus loans held in portfolio by insured depository institutions?
- Are appropriate market incentives and borrower incentives maintained?
- Can the plan be implemented "operationally" by servicers to reach a sufficient number of borrowers on a wide scale basis, but only those borrowers intended to be covered by the plan?
- Does the plan protect servicers and trustees from potential lawsuits by disgruntled investors?
- Should investors fully absorb losses generated by the irresponsible behavior of borrowers, mortgage brokers and others in the mortgage loan process?
- What role should the government play in the process (including, whether the government should back borrowers and/or investors in the process)?
- What are the appropriate economic incentives for investors, borrowers, servicers and the government in a foreclosure prevention plan?
- What other tax and/or accounting issues present obstacles to implementing a viable foreclosure prevention initiative?
- What is the potential long-term impact of the plan, both on the direction of the current housing market and future financing and investment by the capital markets in housing?

These are key questions and the list is not exhaustive. Given the competing interests and concerns, some suggest that the best way to address the current problem is simply to let market forces prevail. Would this work? Ultimately, yes. But it would not be beneficial to permit that to happen. There are responsible "would-be" homeowners who chose not to enter the high-risk housing market of the past several years. What they and everyone else would gain by allowing unaided market forces to sort out the current mortgage market crisis would be perhaps even lower housing prices than in recent months, but this would be offset by significantly higher financing costs and uncertainty in the mortgage and capital markets over the long run.

The impact of the current market situation on mortgage lending and financing has been clear during the past several months. Subprime lending virtually dried up in many parts of the country and, until recently, even the lowest risk jumbo loans have been hard to find at rates remotely competitive with conforming mortgage loans. Both of these types of loan products have been historically funded to a significant extent by the capital markets.

Recently, government initiatives have supplanted the role of the capital markets in some areas by providing relief in the form of additional funding by increasing the conforming loan limit for loans purchased by Fannie Mae and Freddie Mac, as well as the loan limit for loans guaranteed by the Federal Housing Administration (FHA). In addition, the Office of Federal Housing Enterprises Oversight (OFHEO), which regulates the GSEs, recently eased the portfolio limits on Fannie Mae and Freddie Mac, and also reduced by one-third an OFHEO-directed capital surplus requirement imposed on the GSEs. All of these initiatives will increase the ability of the GSEs and the FHA to make mortgage loans, particularly in the jumbo loan market.

Thus, we already have witnessed a relatively robust government response to encourage new lending, along with other quasi-governmental initiatives to prevent foreclosures. However, more needs to be done to address preventable foreclosures. In particular, I believe the benefits of foreclosure prevention are very real and extend far beyond the immediate impact on distressed borrowers and holders of mortgage loans facing foreclosure. This is perhaps the most important aspect of the current foreclosure problem. While a "bailout" of irresponsible borrowers, lenders and investors is not appropriate, it may be appropriate to properly align incentives to protect those who otherwise acted responsibly or were victimized during the past several years. I believe tailoring a solution for this aspect of the issue is in our collective best interest.

It is with this backdrop and pursuant to your request to me a few months ago, Mr. Chairman, that the OTS developed its Foreclosure Prevention Proposal. As you know, the OTS regulates an industry comprising mostly mortgage lenders. Thus, we have extensive experience in aspects of the mortgage markets, including lending, funding and consumer protection issues. In developing our proposal and in fine-tuning it, we have

met with many stakeholders in the mortgage market in an attempt to identify potential pitfalls, and to understand incentives and disincentives at work in the marketplace. In that process, we have learned a great deal about the difficulties that any attempt to address foreclosure prevention will face. Crafting a solution to the current foreclosure challenge requires extreme sensitivity to all of these constituencies, as well as other competing interests. I know that you are extremely familiar with these issues given your own legislative efforts to address the problem. In this regard, you have asked for our thoughts on your proposal, the FHA Housing Stabilization and Homeownership Retention Act of 2008 (the HSHR Act).

A. Overview of the HSHR Act

Based on our review of the major provisions of the HSHR Act draft, it would require the FHA to guarantee up to $300 billion in new mortgages to refinance existing eligible mortgages originated between January 1, 2005 and July 1, 2007 on owner-occupied properties at risk of foreclosure. The proceeds from the new FHA-guaranteed loan would be used to pay off existing lenders or mortgage holders after write-down of the existing loan to an amount approximately equal to 85 percent of the current fair market value (FMV) of the property. In this regard, the loan-to-value ratio of the new FHA-guaranteed loan cannot exceed 90 percent of the current FMV of the property and there is an additional 5 percent of FMV fee payable to the FHA at origination of the FHA-guaranteed loan. This effectively brings the amount payable to the original loan holder down to 85 percent of the current FMV of the property (with no recovery of other prepayment penalties or default/delinquency fees).

In addition to the 5 percent FHA origination fee, the borrower is obligated to the FHA for an exit premium payable upon sale or refinance of the property in an amount equal to at least 3 percent of the original FHA-guaranteed loan. However, for a sale or refinance during the first five years after origination of the FHA-guaranteed loan, the exit premium is equal to the greater of the 3 percent fee or a decreasing percentage of profits from the sale (100% in Year 1, with a 20% reduction in each subsequent year down to 20% in Year 5).

To be eligible for a new FHA-guaranteed loan under the proposal, borrowers must have a mortgage debt-to-income ratio of greater than 40 percent and must certify that they did not intentionally default on their original mortgage loan. And, as highlighted above, the original loan holder must agree to accept an amount equal to 85 percent of the current FMV of the property, with no prospect of additional recovery regardless of the future performance of the underlying collateral.

A final provision of the draft that I want to highlight is a proposed mechanism for the bulk refinancing of existing loans. It is our understanding that this provision is

intended to establish an auction procedure that may or may not be utilized depending on the overall state and stability of the housing markets. While we appreciate the concept of establishing such a mechanism for the bulk refinancing of existing distressed mortgages, the parameters of the program are not entirely clear to us. Of particular concern is the possibility that such a mechanism could further depress housing prices rather than stabilize them. At this time, we withhold any additional comment on the bulk refinancing auction mechanism until we have a better understanding of the intent and application of the provision.

B. Comparison to the OTS Foreclosure Prevention Proposal

The OTS Foreclosure Prevention Proposal (copy attached) is also intended as a mechanism to aid the growing number of borrowers who will find themselves in financial difficulties because their mortgages are "underwater." It is not a "silver bullet" that will provide a single solution to the current crisis. There is no single solution. The intent of our proposal is to provide another meaningful tool to add to the options available for foreclosure prevention and revitalization of the mortgage market.

The OTS proposal has a number of similarities to the HSHR Act draft, including reliance on the FHA to guarantee new loans to replace existing loans held by distressed borrowers in owner-occupied properties. This is a key concept that enables the leveraging of existing governmental resources in a meaningful partnership with private lenders. Ensuring that new FHA-guaranteed loans are based on the current FMV of the property is also a key common element of the proposals. Finally, using the proceeds of the new FHA-guaranteed loan to pay existing loan holders via a short sale or partial pay-off to extinguish their existing mortgage position is also a common element of the proposals. This would provide a significant new tool to servicers and lenders seeking to avoid preventable foreclosures. However, the way this is accomplished is different under the HSHR Act draft and the OTS plan.

First, under the OTS plan, the intent is to provide a negative equity position to the original loan holders in an amount equal to what they are giving up by taking the partial pay-off or short sale from the proceeds of the new FHA-guaranteed loan. This is intended to recognize that the FMV of the underlying real estate collateral may eventually be restored back to its original valuation and that the original lender or loan holder should get the benefit of that appreciation up to the amount originally extended to the borrower. This would also avoid the situation of a future windfall to borrowers whose debt is written down and the value of their home returns in several years to the original loan amount (or more) upon sale of the property.

The HSHR Act draft would prevent a potential windfall to an existing borrower to a more limited degree. The HSHR Act draft would enable a borrower to recoup the entire gain on the sale of the property after five years. In contrast, the OTS proposal does

not provide a time limit on recovery in a subsequent sale, only a dollar limit on recovery equal to the amount of the initial shortfall. While we acknowledge that it makes sense for a borrower to have an incentive to preserve property value and to maximize proceeds from a future sale, we do not believe borrowers should be absolved outright of their prior obligation. The OTS proposal does provide a borrower incentive by allowing the borrower to keep the sale proceeds in excess of the amount due to the original loan holder.

Fundamental to the OTS proposal is the underlying premise that most real estate values tend to increase over time. Assuming this is true with the properties held by many currently distressed borrowers, such borrowers could reap a significant future windfall if they are permitted to retain profits from a future sale rather than making the proceeds available to pay off the remaining amount of their original obligations, which would effectively now be provided to them interest free.

Another important difference between the OTS proposal and the HSHR Act draft is that the OTS proposal would provide to the original loan holders as much of the current FMV of the property as is feasible for a new lender to extend under a FHA-guaranteed loan to minimize the shortfall in the original loan obligation. In contrast, while the HSHR Act draft has a comparable target as envisioned in the OTS plan of issuing FHA-guaranteed loans at or around 90 percent of the current FMV of the property, the draft would impose an additional fee payable by the original loan holder. This fee, equal to 5 percent of the current FMV of the property, would be absorbed by the original loan holder as a reduction in the proceeds payable to the holder. While we understand the merits in imposing this fee may be important, it may make sense to transfer its cost to the borrower that is getting the benefit of the new FHA-guaranteed loan, for example, by tacking the fee onto the back end of the transaction and making it collectible at the time of the subsequent sale of the property. This would still diminish negative equity, but not the upfront short sale payment to the original loan holder.

In sum, Mr. Chairman, the OTS proposal differs from the HSHR Act draft in two important respects. First, it results in less of a shortfall to existing loan holders, which we believe is important to minimize the negative impact on market forces and create incentives for loan holders to participate in the program. We think the key to success for this approach is for the loan services to have enough incentive—through a stake in the future upside potential—to be moved to action to save the home from foreclosure. If the servicer, acting on behalf of the original loan holder, does not have sufficient incentive, then no action will be taken, more homes will be lost to foreclosure and this crucial foreclosure prevention effort will fall painfully short of its mark. In this regard, we would note that the negative equity interest created under the OTS plan has the potential to be shared among existing lien holders, the FHA or other insurer, and the original borrower in whatever manner best aligns their interests to facilitate a foreclosure prevention solution.

Second, the OTS proposal holds existing borrowers to a significantly higher degree of accountability for their past actions. Again, we think this is a highly desirable result from a public policy standpoint. We must remember that while the number of problem loans is large, over 93 percent of homeowners continue to pay their mortgages as agreed, and over 93 percent of mortgages held by the thrift industry are paying as agreed.

For these reasons, Mr. Chairman, we continue to believe that the merits of the OTS proposal – subject to further refinements, including improving borrower incentives to optimize future sale value, should be considered as part of any foreclosure prevention solution. As I stated before, the OTS proposal is not a panacea, but a tool that lenders can use to stem the rise in foreclosures, and we have been encouraged to continue to develop the plan.

V. Conclusion

Thank you, Mr. Chairman, Ranking Member Bachus, and Members of the Committee, for the opportunity to testify on behalf of the OTS on the HSHR Act and foreclosure prevention.

We believe that foreclosure prevention efforts that keep distressed borrowers in their homes by partially paying off their current "underwater" mortgages with an FHA-insured loan and allocating the balance to a negative equity interest offer the best option to reduce preventable foreclosures. A negative equity interest that would pay out in the event of future appreciation upon sale of the property can be apportioned to allow incentives to be aligned in a way that that will maximize the number of foreclosures prevented.

We look forward to working with the Committee to address the continuing challenges in the mortgage markets, and in fashioning a strategy to limit needless and preventable foreclosures. Thank you.

Office of Thrift Supervision Foreclosure Prevention Proposal

Problem: Avoiding foreclosures of owner-occupied properties held in securitizations where a distressed borrower is unable to refinance a loan because the fair market value of the property is less than the current outstanding loan amount.

Objectives:

- Identify a market-driven solution that relies on existing programs, avoids a new government guarantee or assistance, and does not result in the transfer of unacceptable risk to an insured depository institution's books.
- Ensure that the solution minimizes motivations for "gaming" the system by borrowers currently able to pay under their existing loan.
- Avoid providing a windfall to borrowers and investors in the securitization.
- Identify a solution that optimizes investor incentives/motivations to seek it out and maintains borrower incentives to preserve the value of the property.

Solution: Implement a program where:

- Depository institutions offer and underwrite FHA-insured loans based on a percentage of the current fair market value of the property (e.g. 90 percent);
- Proceeds of the new loan are used to provide a partial pay-off of the outstanding balance of the original mortgage loan to the holder of that loan; and
- Existing holders of the original loan receive a "negative equity interest" equal to the difference between the partial pay-off and the balance of the original mortgage loan held by the securitization pool. Alternatively, the negative equity interest could be shared among the existing loan holders, the FHA (or other entity protecting FHA's insurance risk), and/or the borrower/homeowner as needed properly to align incentives.

Pursuant to the program:

- The proceeds of the new FHA-insured loan would be used to pay off the original loan at a discounted payout (i.e., less than the original outstanding loan amount).
- The original loan holder would receive a negative equity interest (as a non-interest bearing second position claim) equal to the amount of the discount between the new FHA loan and the unpaid balance on the original mortgage (however, this amount could be reduced by a designated percentage, e.g., 15 percent, which would be paid to the borrower upon sale in order to maintain incentives to preserve the property and maximize its value at sale);
- Upon a later sale of the property by the borrower, any appreciation in the value of the property (reflected in the sale price) above the discounted payout (i.e., the amount paid to the original loan holder with the proceeds of the FHA-insured loan) would be payable to the holder of the negative equity interest up to the full amount of that interest (less any borrower offset to preserve the value of the property), with any sale proceeds beyond that amount accruing to the borrower.

Justifications/Rationale:

- Provides a market-driven solution that does not "bail out" investors or borrowers.
- Designed to maximize the servicer's recovery of proceeds from the distressed borrower.
- Requires the original loan holder to take a lesser amount when the FHA loan closes, but not a dramatically reduced recovery such as that in a foreclosure of the original loan. This provides an incentive for the original loan holder to participate in the program.
- Avoids a windfall to borrowers by requiring any appreciation in a subsequent sale be paid to holders of the negative equity interest up to the amount of the discount that the original loan holders took when the original loan was cashed out (less any borrower incentive to maintain and maximize the value of the property).
- Relies on an existing framework – including the FHA-insurance – for addressing problem loans in securitizations.
- Creates a potentially marketable financial instrument in the negative equity interest.
- From a tax standpoint, this approach is neutral given that it does not involve forgiveness of debt because the borrower would still be on the hook for upside appreciation and the amount of loss would not be determinable until subsequent sale of the property by the borrower.

Example:

- $220,000 subprime mortgage loan extended in March 2006 on residential property then appraised at $240,000.
- Distressed borrower facing reset in May 2008 that will significantly increase the monthly mortgage payment; borrower will have difficulty making the payment at the reset amount.
- Fair market value of the property is now at $200,000.
- Borrower informs servicer of borrower's financial distress pursuant to inquiry by servicer about the borrower's ability to make the new (reset) payment.
- Servicer refers borrower to FHA-insurance program at ABC FSB that will make a mortgage loan to the borrower at 90 percent of the current fair market value of the property (i.e., a $180,000 mortgage loan).
- Servicer agrees to take $180,000 partial pay-off in order to remove the existing subprime mortgage from the securitization pool, while restructuring the original loan and subordinating its position through retention of a $40,000 negative equity interest that would be payable out of any appreciation in the value of the property (i.e., sale proceeds exceeding $180,000) from proceeds of the future sale of the property by the borrower (and offset by any borrower incentives, e.g., 15 percent of excess proceeds, to preserve/maximize value of the property).
- Borrower has $180,000 FHA-insured fixed interest rate loan with affordable monthly payment; and investors hold a non-interest bearing $40,000 negative equity interest (less any borrower offset) in the property (i.e., a "zero-interest/coupon" second mortgage).
- If borrower sells property in 18 months at a sale price of $236,000, the first $40,000 of the $56,000 difference (appreciation) between the sale price and the refinanced loan amount is payable to the investors (with a percentage to the borrower as an incentive, if applicable) on their negative equity interest in the property.