

Randall S Kroszner: Federal Housing Administration Housing Stabilization and Homeownership Act

Testimony of Mr Randall S Kroszner, Member of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 9 April 2008.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I am pleased to be here today to discuss efforts to address the current problems in the mortgage and housing markets. In my testimony this morning, I will briefly review the current situation in the housing market and ongoing efforts to help prevent avoidable foreclosures. Then I will expand on what additional steps might be taken by homeowners, lenders, servicers, investors, and the Congress to address this important issue. I will also address the need to take the housing situation seriously and some aspects of the discussion draft of the Federal Housing Administration (FHA) Housing Stabilization and Homeownership Retention Act of 2008.

The current situation

The mortgage market has long been a source of strength in the U.S. economy, but it is facing very significant challenges today, especially in the subprime segment that serves consumers who have shorter or weaker credit records. In recent years, slowing home prices and a loosening of underwriting standards have contributed to sharp increases in delinquencies and foreclosures. As of January 2008, the most recent month for which data are available, about 24 percent of subprime adjustable-rate mortgages (ARMs) were 90 days or more delinquent, twice the fraction that were delinquent by this definition one year ago. For mortgages overall, more than 1.5 million foreclosures were started during 2007, up 53 percent from the previous year. All told, the consensus expectation is that the number of foreclosures in 2008 will likely exceed the number in 2007.

Both delinquency and foreclosure are traumatic experiences for the families and communities affected. Recent declines in house prices have eroded the equity that homeowners have in their homes, which has made it difficult or impossible for many of them to refinance their mortgage on more favorable terms compared to their current mortgage, even if interest rates have declined since they took out their loan. Tighter lending standards have also limited opportunities for these families to refinance. When struggling homeowners cannot put themselves on a sustainable financial footing, neighborhoods also suffer – properties are not maintained and foreclosures, particularly when they are clustered together, put further downward pressure on house prices. This is bad news for investors, too, because as property values decline, the substantial costs associated with foreclosure rise even further. Finally, falling home prices can have local and national consequences because of the erosion of both property tax revenue and the support for consumer spending that is provided by household wealth.

Ongoing efforts to help struggling borrowers

Given the high cost of foreclosures to everyone involved – lenders, investors, borrowers and their communities alike – it is in everyone's interest to develop prudent loan modification programs and provide for other assistance to help borrowers avoid preventable foreclosures. Indeed, policymakers and stakeholders have been working hard to find effective responses

to the increases in delinquencies and foreclosures. The steps that have been taken so far include initiating programs designed to expand refinancing opportunities and efforts to increase the pace of loan workouts.

One example of positive steps being taken is the effort by NeighborWorks America and the Homeownership Preservation Foundation to offer financial counseling services through the Homeowner's HOPE Hotline.¹ With the encouragement and leadership of the Treasury Department, the national Hope Now Alliance – a broad-based coalition of government-sponsored enterprises (GSEs), industry trade associations, counseling agencies, and mortgage servicers – is working to find ways to help troubled borrowers, particularly those facing interest rate resets, through loan modification plans.² Recent actions by the Federal Open Market Committee to lower the target federal funds rate and resulting decreases in short-term interest rates also should help mitigate the problems associated with interest rate resets.

Useful steps also are being taken by the FHA, which provides insurance on a variety of fixed- and variable-rate mortgage products that can be used by borrowers who want to refinance their home and who meet specified underwriting and other criteria. For example, the agency recently established the FHASecure plan to help borrowers who are delinquent because of an interest rate reset and who have some equity in their home. FHASecure provides such borrowers the opportunity to refinance into an FHA-insured mortgage. Separately, the FHA's loan limits recently were raised significantly by the Economic Stimulus Act of 2008, further expanding the potential reach of the FHA's mortgage insurance programs. We understand that the FHA is studying additional ways that the agency's insurance programs could be expanded or modified, consistent with existing statutory authorities, to better help troubled borrowers.

The Federal Reserve has been working with financial institutions and community groups around the country to address the challenges posed by problem loans. For example, we have been providing community coalitions, counseling agencies, fellow regulators, and others with detailed analyses that identify neighborhoods with especially high concentrations of foreclosures. Last week the Federal Reserve made available to the public a set of dynamic maps and data that illustrate the regional variation in the condition of securitized, owner-occupied subprime and alt-A mortgage loans across the United States.³ Armed with this information, community organizations and leaders can better target their scarce resources toward helping borrowers in the greatest need of counseling and for other interventions that may help prevent foreclosure.

Communities also are searching for ways to address the challenges that foreclosed homes can present, such as decreased home values and vacant properties that can deteriorate from neglect. Toward this end, the Federal Reserve has recently engaged in a partnership with NeighborWorks America to identify effective strategies to stabilize neighborhoods that have large clusters of vacant properties due to foreclosures. Working together, we will develop materials and tools as well as convene training sessions to help communities build local capacity for acquiring and managing vacant properties. The ultimate goal is to return these properties to useful purposes, whether it is to provide affordable rental housing or to supply new homeownership opportunities in low- and moderate-income communities.

¹ The telephone number for the nationwide Homeowner's HOPE Hotline is 888-995-HOPE.

² Hope Now is an alliance between counselors, mortgage market participants, and mortgage servicers to create a unified, coordinated plan to reach and help as many homeowners as possible. For more information see: www.hopenow.com.

³ The maps show data for each state and for most counties and zip codes. They are available on the website of the Federal Reserve Bank of New York.

Loss-mitigation strategies to reduce foreclosures

In cases where it is not possible for the distressed mortgage borrower to refinance his or her mortgage into a more sustainable mortgage product, the next-best solution may be some type of loss-mitigation arrangement between the lender or servicer and the distressed borrower. The Federal Reserve, in conjunction with the other federal banking agencies (which include the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision), the Conference of State Bank Supervisors and the National Credit Union Administration, has issued guidance urging lenders and servicers to pursue such arrangements, when feasible and prudent, as an alternative to foreclosure. For the lender, servicer, and investor, working out a distressed loan with a struggling borrower makes economic sense if the net present value (NPV) of the payments under a loss-mitigation strategy exceeds the NPV of proceeds that would be received in foreclosure.

Loss mitigation can be advantageous to both the borrower and the lender because the costs associated with foreclosure can be very substantial. Historically, the foreclosure process has usually taken from a few months up to a year and a half, depending on state law and whether the borrower files for bankruptcy. Anecdotal evidence suggests that the time to complete a foreclosure has been increasing recently, as the number of foreclosures has risen and the average time that properties remain on the market has lengthened. The losses to lenders and investors from foreclosures include not only the missed mortgage payments during that period, but also the costs of taxes, legal and administrative fees, real estate owned sales commissions, and maintenance expenses. Additional losses arise from the often significant reduction in value when a property is repossessed even in stable housing markets, particularly if the property is unoccupied for some period. In fact, a recent estimate based on subprime mortgages foreclosed in the fourth quarter of 2007 indicated that total losses exceeded 50 percent of the principal balance. Whether the losses are that large in all cases is difficult to know, but what is known is that the foreclosure process itself destroys considerable value. The existence of such costs raises the real prospect that, by restructuring distressed loans in those cases in which the borrower wants to stay in the home, borrowers, lenders, servicers, and investors may all be able to achieve a better outcome than is attainable if the foreclosure process is allowed to run its course.

Lenders, servicers, and investors have historically relied on repayment plans as their preferred loss-mitigation technique. Under these plans, delinquent borrowers typically repay the mortgage arrears over a few months in addition to making their regularly scheduled mortgage payments. These plans often are most appropriate if the borrower has suffered a reversible setback, such as a temporary illness. However, anecdotal evidence suggests that even in the best-case scenarios, borrowers given repayment plans redefault at a high rate, especially when the arrears are large.

Loan modifications, which involve any permanent change to the terms of the mortgage contract, may be preferred when the higher payments associated with a repayment plan do not result in a sustainable solution. In a loan modification, the borrower's monthly payment is reduced through a lower interest rate, an extension of the maturity of the loan, a write-down of the principal balance, or a combination of all three of these measures. The effort by the Hope Now Alliance to freeze interest rates at the introductory rate for five years for eligible borrowers with an adjustable-rate mortgage is an example of a modification, in this case applied to a class of borrowers.

To date, permanent modifications in this credit cycle episode, as in the past, have typically involved a reduction in the interest rate or an extension of the loan terms, while reductions of principal balance have been quite rare. But the current housing difficulties differ from those in the past, largely because of the pervasiveness of situations known as negative equity positions in which the amount owed on the mortgage exceeds the current market value of the property. A distressed borrower with a negative equity position may have neither the means

nor the incentive to remain in the home. In this environment, servicers and investors may well find principal reductions that restore some equity for at-risk homeowners to be an effective means of avoiding delinquency and foreclosure.

Although principal write-downs may be especially germane today given the prevalence of negative equity positions, they are not necessary or appropriate for all borrowers who have negative home equity or who become delinquent on their mortgage. On the contrary, a strategy of targeting write-downs to certain groups of borrowers may provide the best path forward. For example, one possibility would be to limit the availability of write-downs to those borrowers with high debt payment-to-income ratios and loan-to-value ratios significantly in excess of 100 percent before loan modification, but with the capacity to carry a written-down mortgage. In any event, it seems clear that principal reductions should be part of the tool kit that servicers and investors bring to bear as they deal with delinquent loans.

Additional actions that could help reduce avoidable foreclosures

Several steps could be taken to provide further impetus to loan modifications, including principal write-downs, in appropriate circumstances. One such step that could be taken relatively quickly by the industry is the development of a template that would guide servicers and others as they consider whether, and under what circumstances, to pursue various types of loan modifications, including principal write-downs. Enhanced guidance on loan modifications could help forge a common understanding among servicers and the investor community on when a particular loan modification tool is most appropriate. This guidance would help address the concern expressed by servicers that expanding the rate of principal reductions may expose them to increased litigation risks even in situations where the servicer reasonably determines that such action is beneficial to investors in comparison to other available options. The Hope Now Alliance organized by the industry and the Treasury Department successfully created guidelines dealing with interest rate resets. Leadership also is needed to provide guidance for other loan modification tools and to clarify the "best practices" to be followed by servicers in order to mitigate servicers' litigation risks.

The Congress can take another important step to facilitate greater use of loan modifications by moving quickly to reconcile and enact FHA modernization legislation permitting the FHA to increase its scale and improve the management of potential risks borne by the government. Such legislation could improve the FHA's ability to reach a wider range of borrowers while allowing the agency to develop appropriate underwriting and pricing methodologies for any increased risks assumed.

Separately, the GSEs – Fannie Mae and Freddie Mac – could be asked to do more. Recently, the Congress has greatly expanded Fannie Mae's and Freddie Mac's role in the mortgage market by temporarily increasing the conforming loan limits for these GSEs. In addition, their federal regulator, the Office of Federal Housing Enterprise Oversight, has lifted some of the constraints that were imposed on these entities because they have resolved some of their recent accounting and operational problems. Thus, now is an especially appropriate time to ask the GSEs to move quickly to raise more capital, which they will need to take advantage of these new securitization and investment opportunities, to provide assistance to the housing markets in times of stress, and to do so in a safe and sound manner. As the GSEs expand their roles in our mortgage market, there is a strong need for the Congress to move forward on GSE reform legislation, including the creation of a world-class GSE regulator. As the Federal Reserve has testified on many occasions, it is very important for the health and stability of our housing finance system that the Congress provide the GSE regulator with broad authority to set capital standards, establish a clear and credible receivership process, and define and monitor a transparent public purpose – one that transcends just shareholder interests – for the accumulation of assets held in their portfolios.

Desirable characteristics of an initiative to encourage loan workouts

Going beyond the current proposals for FHA modernization and permitting the FHA greater latitude to set underwriting standards and risk-based premiums for mortgage refinancing – in a way that does not increase the expected cost to the taxpayer – would allow the FHA to help more troubled borrowers. For example, an FHA-insured refinancing product with insurance priced to reflect the risks to the taxpayers might encourage servicers to consider providing delinquent, at-risk mortgage borrowers a principal write-down as a loan modification alternative. The draft FHA Housing Stabilization and Homeownership Retention Act of 2008 includes provisions designed to allow the FHA to offer such products, which could be a useful tool in helping reduce preventable foreclosures.

As you move forward in considering whether to enact a bill and, if so, what its precise design should be, it will be important to consider a wide range of issues. In many cases, a judgment must be made as to how to strike an appropriate balance among competing considerations. Among the issues you will have to consider are at least the following five:

1. *Mitigating moral hazard*

Homeowners who can afford to pay their current mortgage should not be encouraged to default in order to qualify for a write-down. To discourage borrowers who would otherwise have the ability to continue making their payments from becoming delinquent, a variety of steps could be taken. For example, eligibility for assistance under the program could be restricted to borrowers who had relatively high debt payment-to-income ratios at some specified date before the creation of the program. In addition, steps could be taken to make it costly for homeowners who attempt to quickly cash-in on the equity provided through a principal write-down. For example, participating borrowers could be required to pay an exit fee when the refinancing loan is extinguished. As another example, borrowers could be required to share with the government or with the holder of the borrower's existing mortgage either the equity created through a write-down or the future appreciation in the home price, or both, over some specified time period. In other words, the government or investor would have what is known as a "soft-second." In addition, programs that provide for the voluntary participation of lenders and servicers should provide a natural brake on moral hazard, as lenders and servicers would remain free to pursue other options available to them in situations where they believe the borrower has the ability to repay his or her existing mortgage.

2. *Mitigating adverse selection*

A robust defense against adverse selection – the incentive of current servicers or lenders to send only their worst credits to the government-insured mortgage program – is necessary to protect the interests of the taxpayer. Mechanisms that would discourage adverse selection include: (i) a loan seasoning requirement (for example, a period during which the new loan could be sent back to the original servicer/lender if it redefaults) and (ii) a fee structure that imposes costs on the servicer/lender if the new government-insured loan goes bad within a specified period or pays a bonus if the loan continues to perform over the whole of that period.

3. *Turning the FHA into a world-class mortgage insurer*

With modernization and expansion, the FHA could play an important role in relieving stress in the mortgage and housing markets as well as in restarting securitization markets. Securitization markets are needed to help relieve capital stresses on banks and to provide more affordable mortgages to borrowers. To this end, more consideration needs to be given to how the FHA can scale up quickly and improve its processes and underwriting systems so that they are comparable in quality with those currently being used by Fannie Mae and

Freddie Mac. In addition, providing the FHA with broad authority to offer innovative products that meet market needs and to outsource loan underwriting and other program elements to private-sector providers could allow the FHA to insure more mortgage borrowers and to do so more quickly. The FHA needs to be better able to compete in today's marketplace and it needs access to the best risk-management tools available when managing the risks to the government.

4. *Protecting the taxpayer*

Any government-insured mortgage offered under a refinancing program needs to be prudently underwritten, regardless of whether a principal write-down is part of the deal. First and foremost, this means establishing a meaningful amount of homeowner equity. Second, it means using sound underwriting criteria to ensure that borrowers are reasonably likely to be able to repay the government-insured loan on a sustained basis. Third, it means allowing the FHA to engage in sensible risk-based pricing of its mortgage insurance products, including substantial flexibility in setting its initial premium and annual premiums.

5. *Negotiating junior liens*

From one-third to one-half of all subprime mortgages pertain to properties that also have junior liens. When held by an entity other than the first lien holder, these junior liens present a variety of serious obstacles to a successful refinancing, especially one involving a principal write-down. Typically, the junior lien holder must agree either to remove his lien in return for a portion of the proceeds from the refinancing or re-subordinate his claim to the new loan. The valuation of the junior lien holder's claim on the property is often difficult to negotiate. One way of dealing with this problem in the case of a restructuring with an FHA-insured mortgage is to offer a junior lien holder a specified share of the government's or investor's "soft second." Another way of dealing with junior liens is to provide the servicer with financial incentives to aggressively negotiate with the junior lien holder while capping any potential payout available to the junior lien holder from the government program.

Elements of these considerations are already reflected in the discussion draft. For example, Title I of the discussion draft includes exit fees and shared appreciation mortgages to address concerns about borrower moral hazard. It also contains features to protect the taxpayer, such as widening the range of insurance premiums and creating a meaningful amount of borrower home equity. As for adverse selection, risk-based insurance premiums paid by the servicer are crucial, and Title I could be clearer about the FHA's authority to use risk-based premiums. Other steps to guard against adverse selection could include a loan seasoning requirement or other forms of warranties given by the lender to the government about loan performance.

Given the magnitude of the potential foreclosures on the horizon, more steps should be taken to modernize the FHA and to deal with the junior lien holders. The FHA needs the resources and the incentives to manage the risks to the government well and to offer mortgage insurance products that will be attractive to servicers. As for junior lien holders, despite the government's best efforts, it may be difficult for servicers or lenders to negotiate with junior lien holders on the borrowers' behalf. The FHA needs substantial flexibility to provide incentives to servicers to negotiate with junior lien holders to address this difficult problem.

The Congress may be concerned that the loan-by-loan approach could prove insufficient. Title II of the discussion draft would permit substantial flexibility to expand the program if needed by introducing a bulk-refinance mechanism if economic conditions warrant such action. This mechanism would rely on an auction-based process to price and deliver mortgages for refinancing. Note that an auction-based approach would still have to contend with some of the problems mentioned above, including moral hazard, adverse selection and the resolution of junior liens. Title II would grant authority to the implementing agencies to

build in features needed to address these and other issues. If you move forward with this legislation, it will be important that the implementing agencies have full latitude to exercise such authority.

In the design and details of a principal write-down program based on a government-insured refinancing, it is critical to strike the right balance between the interests of borrowers, servicers, investors, and taxpayers. For example, the larger the required principal reduction on a troubled loan, the fewer loans that lenders or servicers will offer voluntarily for refinancing into an FHA-insured product, thereby reducing the "take up" rate for the program. However, a larger principal write-down better protects taxpayers from future losses and gives the borrower a greater incentive to stay current on the refinanced mortgage.

As another example, the more incentives given to servicers to use an FHA refinancing program, either through direct payments or through shared appreciation agreements, the more they would be willing to incur the costs of refinancing borrowers. Such incentives might increase the number of borrowers who might be considered for a government-backed program. But such incentives also would raise the cost of the program for the borrower and possibly for the government as well.

As a final example, providing investors with some of the benefits of any shared-appreciation agreements might encourage them to allow servicers to write down principal and refinance borrowers into a government-backed program. However, providing the government with such agreements could be one means of compensating taxpayers for shouldering the risks associated with the program.

Even if the right balance for the program can be struck, obstacles remain to the successful implementation of a government program designed to forestall preventable foreclosures. For example, even though workouts may often be the best economic alternative, mortgage securitization and the constraints faced by servicers may make such workouts less likely. Trusts vary in the type and scope of modifications that are explicitly permitted, and these differences raise operational compliance costs and litigation risks for the servicer. So that servicers do not try to unduly avoid litigation risks, leadership is needed to clarify their duties.

Conclusion

FHA modernization and GSE reform are needed to address the ongoing shortcomings of current mortgage-oriented government initiatives. In addition, the GSEs should be strongly encouraged to raise additional capital so that they can fulfill the expanded role that the Congress has recently extended to them.

Separately, the Congress should carefully evaluate whether to take additional actions to reduce the rate of preventable foreclosures. Properly designed, such steps could promote economic stability for households, neighborhoods, and the nation as a whole. Although lenders and servicers have scaled up their efforts and have adopted a wider variety of loss-mitigation techniques, more can, and should, be done.

The fact that many troubled borrowers have properties that are now worth less than the principal amounts remaining on their mortgages suggests that lenders and servicers should give greater consideration to the use of principal reductions as one of the loan modification options in their tool kit. Principal write-downs would be facilitated by providing the FHA the flexibility to insure a broad range of refinancing products for a larger number of at-risk borrowers, including products that offer borrowers an affordable, restructured mortgage if their lender voluntarily agrees to write-down the principal amount of the borrower's mortgage. The voluntary nature of the program assures that only borrowers who the servicer or lender believes cannot successfully carry their current mortgage contract would be considered for such a program. If the Congress decides to move down this road, it should carefully consider the steps that should be taken to mitigate moral hazard, avoid adverse selection, and ensure that the financial interests of the taxpayer are adequately safeguarded.