STATE OF MARYLAND
OFFICE OF THE GOVERNOR

MARTIN O'MALLEY
GOVERNOR

STATE HOUSE
100 STATE CIRCLE
ANNAPOLIS, MARYLAND 21401-1925
(410) 974-3901
(TOLL FREE) 1-800-811-8336

TTY USERS CALL VIA MD RELAY

Testimony of Governor Martin O'Malley
U.S. House Committee on Financial Services
"Using FHA for Housing Stabilization and Homeownership Retention"
Thursday, April 10, 2008

Chairman Frank, Ranking Member Bachus, distinguished members of the Committee, thank you for your leadership on this most important of issues, homeownership protection. It is my distinct honor and privilege to testify before you today in support of the FHA Housing Stabilization Retention Act of 2008.

Over the last seven years, we have seen an effort by some at the federal level to do away with regulators and prevent government from intervening on behalf of the common good. Today we see the results: subprime mortgages, communities being prayed upon – an unprecedented foreclosure crisis that threatens the strength and growth of the American middle class.

If we are truly going to see an end to this unprecedented national crisis, we must accept that while government does not have all the answers, it is not the enemy.

Maryland's Response

In Maryland, we identified homeownership protection as an area in which government has an essential role, and an area in which government needed to perform better. In response, we convened a Homeownership Preservation Task Force last summer which brought all the various stakeholders to the table – consumer advocates, the lending community, housing counselors, and State government.

Legislation

Last week, I signed sweeping new legislation born from the Task Force's recommendations, Maryland homeowners will now be guaranteed more time between their first default and foreclosure – valuable time that will allow increase their ability to find a solution and keep their homes.

In addition, thanks to this legislation, lenders will now be required to produce proof of ownership before they may file a foreclosure action, and they must personally serve homeowners to inform them the action has been filed.

Furthermore, this legislation cracks down on unscrupulous predatory behaviors. Now, anyone who commits mortgage fraud in Maryland will be subject to criminal penalties – a clear message that we will not tolerate unscrupulous and corrupt mortgage lending activity. And, we have banned the despicable practice of "foreclosure rescue scams," which prey on homeowners in our most vulnerable communities and strip them of the equity in their homes.

On Tuesday, I signed an additional piece of our legislative package which will tighten lending and licensing standards in Maryland. Lenders and brokers will now be required to verify a borrower's ability to repay a loan – and if the loan has a "teaser" rate, the borrower must qualify for the loan at the fully indexed rate.

This legislation also banned pre-payment penalties for mortgage loans, assuring that refinancing out of inappropriate loan products will not be cost-prohibitive. Mortgage licensees will now be required to have a minimum net worth and have adequate surety bonds to protect consumers.

Further Actions

In addition to legislative reforms we have undertaken several measures to help alleviate this crisis.

Earlier this year we launched the Bridge to HOPE loan program, which provides small, deferred loans to homeowners to allow them to get caught up on their mortgage, and find a better solution than foreclosure. We also created the Lifeline Loan Program and the Homesaver Refinance Mortgage Program to help us refinance homeowners out from under burdensome loans.

Additionally, recognizing the important role housing counseling can play in helping prospective homeowners avoid pitfalls - and in helping existing homeowners avoid foreclosure - we provided grants to housing counselors in our state to partner with us in this crisis.

We are working with lenders to create loan products that will allow government and private lenders to share the risk associated with refinancing loans for borrowers in default, and we are exploring ways to provide incentives for banks to participate.

A Partnership with the Federal Government

Although we are making steady progress in Maryland, our ultimate success depends on a successful partnership with the federal government. I applaud your leadership on this issue, and believe the legislation under consideration today would be crucially important to our efforts.

The Need for Counseling

Housing counselors are a critical resource both for existing homeowners who find themselves facing foreclosure, and for prospective homebuyers who often do not understand the buying and lending process. Oftentimes, homeowners facing foreclosure never pick up the phone to contact their lender. In Maryland, we have tapped local housing counselors to help homeowners interact with their lenders and to help them find much needed solutions.

I strongly support the provisions in this bill to expand housing counseling by authorizing $200 million for these purposes. Further, this should be a multi-year effort, since it will take time to work through the entire foreclosure crisis. I would also request that the legislation include provisions for HUD to conduct public outreach efforts to encourage owners at risk of foreclosure to contact housing counseling agencies. Educating current and potential homeowners about the home buying and foreclosure processes is critical, particularly when dealing with subprime and predatory lending.

The Need to Acquire, Rehabilitate, and Re-sell foreclosed homes

Foreclosures have a devastating effect on homeowners and their communities. When a homeowner loses his or her home to foreclosure, so often their equity is also lost. Depressed home values and the blight caused by vacant housing can destabilize communities as they turn from homeownership to investment or rental communities. Governments lose tax revenues and often must bear the cost of foreclosure sales.

The proposed $10 billion fund administered by states to acquire, rehabilitate, and sell foreclosed homes will provide a critical tool to curtail the negative impacts foreclosures have on our neighborhoods and communities. As proposed, the income targeting directs assistance to those most in need while supporting mixed income communities. I support the provisions that allow these funds to be used to make homes affordable for low and moderate income families. Soft seconds – deferred loans that maintain property values while making the home affordable – as well as carrying costs, allow for the financial success of this strategy.

In addition, it is important for states to be able to use the funds for short-term bridge financing. In our experience, many homeowners wait until foreclosure is imminent before seeking assistance. Short term bridge loans that cover the mortgage between time of reset and refinancing will allow many owners to remain in their homes. Despite our best efforts, some homeowners will lose their homes in this crisis, and I would support the ability to use these funds for short term rental assistance and for security deposits. As homeowners lose their homes, it is critical that government help them avoid homelessness and make the transition to renting and redirect funds for rental payments.

I would also recommend eliminating the provision that limits this program to houses with purchase prices that do not exceed 90 of the average area purchase price. Instead, I recommend flexibility to allow states to finance homes affordable within program income limits. As it stands, it will be extremely difficult to establish average area purchase price because 1) it will be hard to determine what constitutes an area, and 2) home prices are changing on a monthly basis. In addition, by limiting the program only to homes with prices below the market, the program may result in depressing the market even further. Also, where foreclosures have hit a particular neighborhood disproportionately, limiting the purchase and rehab to a certain number of homes will not produce the impact on a neighborhood that we are seeking through this program.

Expansion of FHA Capacity

In our experience in Maryland, getting mortgage servicers to participate in efforts to deal with the foreclosure crisis has been one of the most difficult aspects of this problem. They "talk the talk" but do not "walk the walk."

I support the expansion of FHA loan guarantees to help deal with the subprime and foreclosure crisis, and believe the following modifications would make the provisions even more effective to get lenders and, in some cases, borrowers to participate in the program:

FHA Guarantee Amount

The FHA legislation proposes that homes insured under the proposal should not exceed more than 90 percent of current value. In addition, it requires a five percent premium for potential additional losses. This represents a 15% reduction from the current value of a property (10% below value plus 5 percent premium) for the newly insured FHA amount. Given that home prices are declining, this provision may place a damper on the willingness of servicers to participate with FHA in this program, as they may feel its losses would be unacceptably high.

For example, if a home loan was originally made for $120,000 and the home is now worth $100,000, the current proposal calls for FHA to insure 90% of the current value, or $90,000. In addition, the legislation requires the lender to pay an additional 5%, or $5,000, for an insurance premium to FHA. This means the lender would effectively receive $85,000 from FHA for the mortgage, an effective loss to the lender of almost 30% from the original $120,000 loan amount. The lender may recover a higher ratio of funds if he allows the property to go into foreclosure.

I believe a better approach would be to allow properties to be refinanced at the current FHA loan to value ratio of 97%. In that case, with an original mortgage loan amount of $120,000, and a current value of $100,000, an FHA guarantee of 97% would put the difference between the original loan amount and the new guarantee at about 19%, a more acceptable loss ratio to lenders.

Equity Distribution

As structured, we believe the FHA proposal would provide too much equity to FHA when costs of rehabilitation are taken into account. Under this proposal, FHA would recover a percentage of equity, based on how long the owner owned the property, including improvements made by homeowners. It would be fairer to develop an equity sharing schedule based on an adjusted basis of the federal government's investment and the owner's investment. This will cover the need for both FHA and the government to prevent unfair profit taking, while not penalizing owners who have made improvements to their property with private resources.

Underwriting Standards

Under the proposed legislation, if there are higher than acceptable debt ratios (more than 40% but less than 50%), the proposal requires banks to hold loans for six months before FHA purchases the mortgage. We understand FHA's reluctance to take on these loans. However, it would be easier and fairer for FHA to establish regulations on mortgages it will or will not accept. This takes the guesswork out of the process for lenders, FHA and borrowers who will not be once again put into loans they cannot afford.

Timing

The legislation as proposed restricts the program only to mortgages originated between January 1, 2005 and July 1, 2007. The subprime market began to expand greatly in 2001, and many homes that have fallen into or are at risk of falling into foreclosure were financed before January 1, 2005. I would recommend moving the start date for originations back to January 1, 2003, to capture certain types of loans, such as 35 year loans where the first five years where interest only. In addition, the legislation should make clear that FHA will purchase loans that have already been refinanced by Housing Finance Agencies in response to the foreclosure and subprime crisis.

Other issues

While the FHA Housing Stabilization and Homeownership Protection Act would make considerable progress toward address the foreclosure crisis, I would like to bring to your attention two additional areas that should be considered in order to make the response to the foreclosure crisis comprehensive and most effective:

The Need for Permanent Financing

A $10 billion expansion of the Mortgage Revenue Bond Program (MRB) would create a source of permanent financing to assist homeowners with subprime, ARMs, and other exotic mortgages, such as 2/28 or 3/27 loans, to refinance out of those loans. States have successfully used the MRB program for years to help first time homebuyers. But due to the program's success, states have reached federally mandated volume caps. We must expand resources to allow the program to assist current owners in need of refinancing. Authorizing language in this legislation would make such loans possible.

The Need for Short and Long Term Resources for Renters

The influx of former homeowners into the rental market will put considerable pressure on the tight rental housing market, driving rents up beyond affordable levels for many families. An increase in the cap on Federal Low-Income Housing Tax Credits will allow more affordable rental housing for low-income households, which will be particularly hard hit as the rental market becomes increasingly competitive.

Non-Pre-emption

Maryland, along with many other states, has responded aggressively to this crisis by enacting legislation and strengthening regulatory oversight. We ask that any federal legislation adopted does not pre-empt states from doing more to protect homeowners.

Conclusion

Homeownership is the cornerstone of the American dream – a pathway into the middle class for so many who dream of building better lives for themselves, and for their families. It is, in a very real sense, the soil from which communities grow and it instills in residents an increasing stake in the common good and collective prosperity.

To lose even one home is a tragedy; to lose thousands is a threat to the growth and vitality of the American middle class.

We have a responsibility to act, and to act quickly.

I would like to thank Chairman Frank, Ranking Member Bachus, and the distinguished Members of the Committee for giving me this opportunity.