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"Homeowner Downpayment Assistance Programs and Related Issues"

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Madam Chairwoman, Ranking Member Biggert, and members of the Subcommittee, thank you for inviting HUD to participate in this hearing. My name is Meg Burns and I am the Director of the Office of Single Family Program Development for the Federal Housing Administration (FHA). I appear today representing FHA Commissioner Brian Montgomery, who sends his regrets that he is unable to attend.

I have been asked to testify on the recently-published proposed rule, which continues HUD's long-standing policy of permitting FHA borrowers to rely on downpayment assistance from family members, employers, governmental entities, or charitable nonprofits, but clarifies that the funds cannot be derived from sellers or any other party that stands to benefit financially from the purchase transaction.

As you may know from previous public statements and testimony offered by the FHA Commissioner, our agency has been concerned with seller-funded downpayment assistance for some time now. While well intended, the programs have had a significant negative impact on FHA's business for the last several years. Loans made to borrowers who rely on these types of seller-funded gifts perform very poorly. The foreclosure rates on these loans are more than twice those of all other home purchase loans insured by FHA. Moreover, FHA experiences higher loss rates from the sale of the properties associated with these particular foreclosures, a reflection of the overvaluation that occurs with these programs. The higher foreclosure rates represent a financial burden for FHA and taxpayers, but of greater concern, they hurt the families who lose their homes and the neighborhoods in which those homes are located.

The core problem with these programs is not that the borrowers they serve are riskier or less credit-worthy; it's that the programs disrupt the natural negotiations between buyers and sellers in a way that results in inflated sales prices and thus higher mortgage amounts. Seller-funded downpayment assistance programs flourish in weak real estate markets. In weak markets, low buyer demand means that sellers are less likely to get full asking price for their homes and are therefore willing to participate in programs that will help them sell for a higher price. As such, the property overvaluation associated with seller-funded gift programs occurs in markets that are least able to adjust to and accommodate pricing variations.

For example, in fiscal year 2006, more than 50 percent of FHA's purchase mortgage business in both Ohio and Indiana was for borrowers who relied on nonprofit seller-funded gifts. In these states, home values have been stagnant or declining. In soft housing markets, borrowers with no or negative equity who face any kind of financial hardship have fewer options to recover and can slip into foreclosure fairly quickly, despite the best efforts of FHA's loss mitigation programs. High foreclosure rates in these communities contribute to additional deterioration in home values and a vicious cycle of property depreciation.

The harmful effects of seller-funded downpayment assistance were highlighted in 2004 and 2005 studies prepared by Concentrance Consulting, on behalf of FHA, and the U.S. Government Accountability Office (GAO). In 2006, the Internal Revenue Service (IRS) issued a ruling that provides guidelines for organizations that provide downpayment assistance. The IRS, in its press announcement of the ruling, stated that funneling downpayment assistance from sellers to buyers through "self-serving, circular-financing arrangements" is inconsistent with operation as a section 501(c)(3) charitable organization.

So why has FHA taken the approach that it has and why now? Prior to November 2006, FHA publicly acknowledged the problematic nature of the seller-funded gift programs, stating on several occasions that these programs pose a higher cost and risk to borrowers and to the soundness of FHA's insurance fund. However, the agency resisted development of an outright prohibition of seller-funded gifts, pursuing instead an alternative FHA financing arrangement for borrowers lacking the funds for a downpayment.

FHA sought legislative authority to eliminate its own 3 percent cash investment requirement: to offer cash-poor, but creditworthy, borrowers a safer, more affordable alternative to the seller-funded gift programs. It was our view that a modernized FHA would reduce borrowers' reliance on seller-funded gift programs, an outcome that would be good for borrowers and taxpayers. Because congressional efforts have yet to result in FHA being permitted to offer better and more flexible financing options, we determined it was time for our agency to stop recognizing this particular type of assistance.

As you have heard Commissioner Montgomery state many times, FHA financing is the most consumer friendly on the market today, helping families access *prime* rate mortgages. FHA financing has none of the harmful features that are common in the subprime market, features that have been the subject of much congressional discussion and debate. FHA does not permit prepayment penalties or negative amortization; FHA requires lenders to escrow for taxes and insurance; FHA underwriting ensures the borrowers' capacity to repay meets a suitably high threshold; and FHA requires evidence of a borrower's income and employment. In essence, FHA makes it possible for first-time homebuyers to obtain home financing that is safe and fair and affordable.

That is our objective at FHA – to help borrowers who otherwise wouldn't qualify for prime rate financing. We want these families to receive the tremendous protections offered by FHA, both through FHA's underwriting and in the form of our successful loss mitigation program. And we continue to work with this Committee to enact needed reforms that would help our traditional borrowers, such as risk-based pricing and "Zero Down" financing.

But now, we find ourselves in a position where we can no longer sit back and wait for that alternative. If we did nothing, some would appropriately question FHA's capacity to manage risk and FHA's own data shows that the poor performance of the loans to borrowers using seller-funded gifts must be addressed as soon as possible.

I want to conclude my testimony by thanking this Committee for the bipartisan support and leadership it has shown on FHA Modernization. I also want to point out that if enacted, both the legislation introduced by Chairwoman Waters and the legislation introduced by Ranking Member Biggert, by authorizing FHA to insure "Zero Down" mortgages, would go a long way toward resolving the issue before us today.

Thank you for having me here today and I'd be happy to answer any questions you may have.