S. HRG. 111–854

# THE FEDERAL HOUSING ADMINISTRATION— CURRENT CONDITION AND FUTURE CHALLENGES

## HEARING

BEFORE THE

## COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE CURRENT CONDITION AND FUTURE CHALLENGES OF THE FEDERAL HOUSING ADMINISTRATION

SEPTEMBER 23, 2010

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# C O N T E N T S

## THURSDAY, SEPTEMBER 23, 2010



## WITNESSES

# THE FEDERAL HOUSING ADMINISTRATION—CURRENT CONDITION AND FUTURE CHALLENGES

**THURSDAY, SEPTEMBER 23, 2010**

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
*Washington, DC.*

The Committee met at 10:23 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Christopher J. Dodd, Chairman of the Committee, presiding.

## OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. Again, we are a little late getting started here this morning, and I apologize to my colleagues. But we have two very good witnesses here this morning to talk about this very, very important program, and I am delighted they are here.

I have a brief opening statement, and then I am going to turn to my colleague from Alabama, my friend Richard Shelby. And we have been joined by Senator Merkley, Senator Reed, and Senator Corker as well. There is a strong interest in this subject matter, and so we will try and move along here this morning, if we can.

I want to welcome the Members of the Committee and our two witnesses to this hearing, "The Federal Housing Administration—Current Condition and Future Challenges." The Federal Housing Administration, FHA, has played a very critical and dramatic role in maintaining access to mortgage credit for millions of our fellow citizens at a time when the private sector has effectively disappeared from the marketplace. I think we would all agree to that point.

According to recently released Government data, FHA along with VA and rural housing programs accounted for half—54 percent—of all home purchase mortgages in the year 2009 and about 30 percent of all mortgages, including refinances. Together, with Fannie Mae and Freddie Mac, the Federal Government now stands behind more than 90 percent of the entire market. In short, if it was not for FHA, the amount of mortgage credit that would be available for home purchases would be cut in half. This would result in sharply lower demand and drive home prices further down, further stripping American families of the hard-earned home equity they have acquired over the years. In other words, FHA is doing what it has done for decades. It is playing a stabilizing force in our housing and mortgage markets. It is because of the central role that FHA is playing now and will continue, in my view, to play in the future that we need to ensure that the Federal Housing Administration is on a solid financial footing.

There are clearly legitimate reasons for concern which have been expressed by many on this Committee. In 1990, the Congress established a minimum capital ratio for FHA of 2 percent. That capital cushion was established to make sure that the program premiums would be there to pay for its losses, with some margin of error. Last year, the annual actuarial report noted that the capital cushion had declined to only 0.5 percent, a dangerously low figure. Moreover, serious delinquency rates reached all-time highs at the end of 2009. I hasten to add, however, that even at their worst, FHA's delinquency rates were less than one-third of those for subprime mortgages. This is a tribute to the fact that FHA has insisted on real underwriting.

Just to give you an idea, by the way, in the prime real estate market, the foreclosure rates—delinquency rates, excuse me, were 7 percent, the subprime were 30.6 percent, and FHA was 9.4 percent. I think it is very important to cite those numbers because I think there is an impression that the FHA delinquency rates were hovering around the subprime rates, and they were much more closer to the prime rates—a little bit higher, by 2.5 percent higher than prime rate delinquencies. Delinquencies at prime rate at 7 percent, FHA at 9.4 percent, and subprime at 30.6 percent. So we are much closer to the prime, and I think those numbers are kind of important to keep in mind as we talk about what needs to be done.

I for one do not find it surprising, obviously, that FHA has lost money or that it suffered higher delinquencies and foreclosures in the midst of the worst housing crisis that this Nation has experienced since the Great Depression. However, we do not want a program to continue operating with such a capital margin. That is unacceptable. So my point in making these statistics is not to minimize the importance of addressing the capital margins that have to be faced.

So the purpose of this hearing is to examine what steps FHA is taking to restore its capital cushion consistent with its goals and mission to provide access to mortgage credit to traditionally underserved borrowers. I will say without preempting anyone's testimony, Commissioner Stevens, that you and Secretary Donovan, in my view, have been very active in addressing numerous operational and program weaknesses at FHA. As a result, the quality and performance of the portfolio has improved significantly, and the program seems to be on a far more solid footing.

In addition, FHA has strengthened its oversight of lenders. It is demanding higher performance from originators, strengthened underwriting standards, and has increased enforcement which has forced the industry to sit up and take notice. I strongly commend you and Secretary Donovan for the steps that you have been taking.

However, as the GAO points out, while applauding your progress, there is far more to be done. We all agree with that. I certainly do. So I look forward to hearing your testimony this morning and working with you in the remaining weeks of my tenure here, as I am sure the Members at this dais already who have a strong interest in this subject matter. And I see Michael Bennet of Colorado has joined us, and Tim Johnson is here as well. We will have a continuing interest in the subject matter when the new Congress convenes in January.

With that, let me turn to my colleague from Alabama.

**STATEMENT OF SENATOR RICHARD C. SHELBY**

Senator SHELBY. Thank you, Mr. Chairman. Thank you for putting this hearing together.

Last August, Congress passed emergency legislation to provide the Federal Housing Administration additional flexibility in assessing annual premiums on the loans that it insures. The legislation also required that the FHA Commissioner come before this Committee "to discuss the finances, including premiums," of the Federal Housing Administration. Congress provided the premium assessment flexibility at the request of FHA.

Commissioner Stevens stated at the time, and I quote, "Without this authority, FHA will face increasing challenges in meeting multiple mandates to serve underserved borrowers, maintain the congressionally mandated capital reserve ratio, and provide liquidity to the market."

Today, I look forward to examining not only how the FHA fund reached the point where emergency action was required, but also those steps we should consider here to improve FHA's long-term viability.

In addition to fulfilling the statutory requirements for FHA to appear before this Committee, this hearing provides a valuable opportunity for us here to hear from the GAO, the Government Accountability Office. Earlier this year, Chairman Dodd and I asked the GAO to examine the FHA fund, and today we will hear the results of that examination.

We know that the capital reserves of the fund have fallen to critical levels in recent years. We also know that many new loans have not matured enough for their impact on the fund to be fully known yet. But given the hundreds of billions of dollars in taxpayer-funded bailouts to the auto companies, to Fannie Mae, and to Freddie Mac, I believe we must do everything here in our power to prevent the American people from having to pay for yet another Government bailout. This will not be an easy undertaking, and certainly it will not be popular with many special interest groups. Nevertheless, I believe it must be done so that the most important special interest group—the American taxpayers—are protected.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

Do any of my colleagues here want to make a quick opening comment? If not, I will introduce our witnesses. I thank my colleagues. Bob, the Corker rule prevails.

[Laughter.]

Chairman DODD. The Corker rule lives.

Let me first of all introduce David Stevens. I want to welcome him back. Commissioner David Stevens is the Assistant Secretary for Housing at the United States Department of Housing and Urban Development, as well as the Commissioner of the Federal

Housing Administration. He has significant real estate experience based on many years of experience.

In fact, I remember just going through your nomination process and how thrilled I am, and I think the Committee, that you stuck with it. We went through a couple of rough weeks there, but I cannot tell you how fortunate we are to have you and have someone with your practical experience in this field, something that is not prevalent throughout the Administration, I might point out, but to have people like you who actually know what it is every day to get out and deal with these issues is very, very valuable.

Bob Corker knows about it. Obviously, he was involved in the business and knows practically what it is like, and to have someone in a policy position who knows what it is like has been tremendously helpful. So I am glad you are with us, and I am anxious to hear your thoughts this morning. You have direct responsibility for oversight and Administration of the FHA insurance portfolio, which includes single-family and multifamily housing, insured health care facilities, and other programs. Again, we are pleased to have you with us.

Mathew Scirè is a Director of GAO's Financial Markets and Community Investment team, with almost 30 years of audit experience, and currently is responsible for leading GAO's audit work involving housing programs. His team is focusing on a wide range of issues, including FHA's mortgage insurance program, Treasury's loan modification efforts, and the use of Recovery Act funds by public housing agencies and others. And, again, I always say that we are so fortunate to have GAO. It does actually just a fabulous job. You are highly regarded and thought of, and so we thank you for coming before us today as well.

Mr. Stevens, we will start with you and then turn to Mr. Scirè, and then we will open up the floor for some questions. Take about 5 minutes or so, if you would, 5 or 6 minutes. By the way, we will take any and all supporting data, evidence, testimony—not only from you but from my colleagues—and it will be included in the record.

**STATEMENT OF DAVID H. STEVENS, FEDERAL HOUSING AUTHORITY COMMISSIONER AND ASSISTANT SECRETARY FOR HOUSING, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Mr. STEVENS. Thank you, Senator. Chairman Dodd, Ranking Member Shelby, Members of the Committee, thank you for the opportunity to testify today on the financial condition of the Federal Housing Administration. I have submitted a longer document to the record.

With Congress's help over the last year, FHA has made significant reforms that have put the agency on a stronger financial footing. I would like to discuss those reforms today and explain why our ability to protect the taxpayer for the future depends on Congress enacting the broader, more comprehensive set of reforms we have proposed.

As you know, last year we informed Congress of the independent actuary's findings that the FHA's secondary reserves had fallen below 0.53 percent of the total insurance-in-force, below the required 2-percent level. I told you then that Secretary Donovan and I would do everything in our power to ensure that the taxpayer was protected. And today, while we are by no means out of the woods, we have made significant headway toward stabilizing the portfolio.

In fact, according to our third quarter report submitted to Congress, instead of losing $2.6 billion in funds, as the actuary predicted, FHA has generated an additional $1.3 billion in capital resources through the third fiscal quarter and continues to earn more funds for the taxpayer. Furthermore, actual foreclosures of FHA-insured homes have been 20 percent less than projected, which is why we have paid $3.7 billion less in claims than projected. This was only possible because the Administration had already begun implementing the most sweeping set of reforms to FHA's credit policy, risk management, lender enforcement, and consumer protections in the agency's history.

Mr. Chairman, last year we said we would hire the first chief risk officer in the organization's history, and with congressional approval, we have formally established a permanent Risk Management Office within FHA, headed by a Deputy Assistant Secretary, allowing us to assess and analyze risk more accurately and more proactively. We also said we would strengthen our lender enforcement policies, and we have, eliminating FHA approval for loan correspondents and increasing minimum net worth requirements for lenders who participate in the program.

We suspended some well-known FHA-approved lenders and withdrawn FHA approval for over 1,500 others, and I have imposed over $4.25 million in civil money penalties and administrative payments to noncompliant institutions.

We are sending a very clear message. If you do not operate ethically and transparently, we will not do business with you.

We said we would restructure our mortgage premiums, and we have. In April, we raised them from 175 basis points up front to 225 basis points across all FHA product types. In early October, thanks to legislation passed here, we will reduce the minimum premium up front to 100 basis points, offset by an increase in the annual premium to 85 or 90 basis points, depending on the loan-to-value ratio. On behalf of the Secretary and myself, I want to thank the House—the Senate, excuse me, and particularly you, Chairman Dodd, and Ranking Member Shelby, for your leadership in passing this important legislation.

In addition, we said we would improve the quality of the loans we make, and we have. We have strengthened credit and risk controls. We have implemented a two-step FICO floor for FHA borrowers. Purchase borrowers with credit scores below 580 are now required to have a minimum 10-percent down payment to get an FHA loan. And only those with stronger credit can continue to get the FHA program with that minimum 3.5-percent down payment.

We also promised to reduce seller concessions which often create incentives to inflate appraised value and are significantly more likely to go into default. That is why we have proposed to reduce the maximum allowable seller concession from 6 percent to 3 percent.

Last, we said we would modernize the technology within the FHA, and with your help, we have made great strides toward improving technical capacity to handle the increased volume, delivering our first comprehensive technology transformation plan to Congress, and modernizing FHA's technology infrastructure. We have also awarded three contracts to upgrade our risk and fraud tools and are building staff capacity through hiring and training. The early results of these efforts are encouraging. I mentioned that our capital reserves are growing faster than projected and that claims payments are less than forecasted.

Loan quality is improving as well. Our third quarter report shows that loan performance, as measured by serious delinquencies and early period delinquencies, has improved significantly, with the first year-over-year decline in 90-day delinquencies in years. The average credit score in our current insurance endorsements has risen from 634 in 2007 to near 700 today.

Going forward, the President's budget projects that these actions will produce an additional $4.1 billion in FHA receipts in fiscal year 2011, funds that FHA earns for the taxpayer.

Of course, despite the progress we have made, Mr. Chairman, the job is far from over. Secretary Donovan and I remain committed to comprehensive FHA reform legislation. In August, Senators Mark Begich and Sherrod Brown introduced Senate bill 3704. This bill is similar to the House-passed H.R. 5072, which would give FHA the tools necessary to manage risk, protect the fund, and protect the taxpayer.

In addition to strengthening FHA's lender enforcement ability, the bill will allow for third-party loan originators to close FHA-insured loans in their name and extend FHA's ability to hold all lenders to the same standard by permitting us to recoup losses through required indemnification for loans that were improperly originated or in which fraud and misrepresentation were involved.

Building a strong foundation for the future requires us to pass this legislation, and I hope that you will pass it by the end of the year.

Mr. Chairman, these reforms are important not only because we still have a long way to go, but because home prices may still decline further, and conditions may get worse before they get better. They are also important because we know the critical role FHA is playing in the housing market right now.

Mr. Chairman, this makes it even more important that we continue to deliver on our commitments to strengthen the FHA and assist responsible home borrowers who need a helping hand while working to facilitate the return of private capital to the housing market. We look forward to working with Congress closely on all of these issues as we further reduce risks to the American taxpayer and ensure FHA can continue to provide stability to the housing market at a moment when it is most needed.

Thank you for the opportunity to testify, and I look forward to answering any questions.

Chairman DODD. Thank you very much for that.

Mr. Scirè.

**STATEMENT OF MATHEW J. SCIRÈ, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. SCIRÈ. Mr. Chairman, Ranking Member Shelby, Members of the Committee, thank you for the opportunity to be here today to discuss FHA's mortgage insurance program.

Since 1934, FHA has been an important player in the mortgage market, especially for first-time home buyers. FHA insures these loans under its Mutual Mortgage Insurance Fund. Almost 1 year ago, HUD released the results of the latest independent actuarial review showing that the capital ratio used to measure the financial soundness of the fund had declined to 0.53 percent, well below the statutory minimum of 2 percent.

At the request of this Committee, we have been evaluating the program and issued our first report yesterday. Overall, our work pointed to further actions needed to better evaluate the fund's financial condition and guidance for rebuilding the capital ratio.

Let me start by describing the reasons for the capital ratio's steep decline since its peak in 2006. Put simply, the capital ratio declined because its numerator—the economic value of the fund—declined sharply while its denominator—the insurance-in-force—grew rapidly.

Let us take first the insurance-in-force. This measure of the amount of all loans FHA insures rose as the demand for mortgage insurance grew. By the end of 2009, FHA had outstanding insurance that was more than 6 times the level it had at the end of 2006. The decline in the fund's economic value is due to several factors, including more pessimistic forecasts for house prices, which would result in higher claims, and more pessimistic assumptions about losses. From a budgetary perspective, the worsening expectations for loan performance ultimately resulted in HUD recognizing a $10 billion increase in the cost of the program in 2009 alone and a like reduction in the program's capital reserve account. If this account, which now stands at $3.5 billion, were to be depleted, FHA would require additional Federal funds to cover its cost on outstanding insurance.

It is important to note that the economic value of the fund depends in large measure on cash-flows derived from estimates of loan performance over a 30-year period. FHA and its contractor have enhanced their methods for assessing the fund's financial condition, but there is more that FHA can do to improve the reliability of its estimates. In particular, past reviews have relied on single economic forecasts to determine compliance with the 2-percent requirement. However, this approach does not fully account for the variability in future house prices and interest rates and, therefore, may tend to overestimate the fund's value.

We recommend that FHA use an alternate approach known as stochastic simulation to estimate the fund's capital ratio for purposes of assessing compliance. This approach uses hundreds of different economic paths and offers the prospect of more reliably estimating the fund's economic value.

Beyond steps to improve how it measures the fund's health, FHA has also taken proposed steps for improving the fund's financial condition, and the Commissioner describe many of those. However, FHA has not specified when it expects to return the fund's capital ratio to its minimum 2 percent, nor what further steps it needs to take to do so. Likewise, the Congress in 1990 specified when it expected FHA to first reach a 2-percent ratio. It did not specify what it expected of FHA should the ratio subsequently fall below 2 percent or specify a timeframe for returning the capital ratio to 2 percent.

Finally, we report on changes in the performance and characteristics of FHA loans. The delinquency rate for FHA-insured loans increased in recent years. However, in some respects, the characteristics of the most recent FHA loans are less risky than in past years. An increasing share of FHA-insured loans went to borrowers with higher credit scores, for example. Also, loans with seller-funded down payment assistance are no longer permitted.

On the other hand, FHA insured relatively more streamlined refinance loans in 2009. But probably most important to consider is the sheer size of recent loan cohorts. Because these loans now represent a substantial portion of FHA's portfolio, they will be important to the future of FHA and its efforts to rebuild the financial condition of the fund.

Overall, the challenge FHA faces today is not dissimilar to that it faced nearly 20 years ago when it was first required to achieve a 2-percent capital ratio. It met that challenge in 5 years. Then, as now, it may be necessary for the Congress to specify the time period it expects FHA to return the capital ratio to 2 percent, taking into account FHA's statutory operational goals and its role in supporting the mortgage market. Also, to provide the Congress with more reliable estimates of the fund's value, there is more that FHA can do to more fully recognize the impact that volatility in house prices and interest rates may have.

We are committed to providing the Congress with effective oversight of the FHA program, including its efforts to rebuild the fund's capital ratio, while serving an important role in the mortgage market. We look forward to supporting the Committee's efforts.

This concludes my opening remarks. Thank you again for the opportunity to speak today. I would be glad to take any questions that you may have.

Chairman DODD. Well, thank you again, Mr. Scirè, and thank you and your staff as well for the work you have done.

Let me jump right in, and I will ask the clerk to put around 6 minutes or so on here so we can give everybody a chance to get involved in this discussion.

Let me ask you, Mr. Stevens, Commissioner Stevens, a contemporary question. We are going to be passing a continuing resolution, I think probably next week, that will carry us over I think until December at some point. But one of the items that I hope gets included in that CR is a 1-year extension of the expanded loan limits for FHA and the GSEs. Commissioner Stevens, can you speak to the issue and why it is important to do this prior to leaving for our election recess?

Mr. STEVENS. Thank you for the opportunity to answer that specific question. At this point, as you stated in your opening remarks, between Freddie Mac, Fannie Mae, FHA, and VA, we play a critical role in providing needed financing for every homeowner in America today. And there is still a significant gap in any available private capital to come into the market at virtually any price.

The issue for FHA in particular in extending the limits is not about the maximum dollar amount. I think it is important for everybody to recognize that. Less than 3 percent of our portfolio is over $417,000. We are doing very few large loans.

The real issue is the formula itself. FHA's floor today under HERA is $271,000, and it is based on a formula based on median sales price. If the limits were not extended for another year, we would, A, recalculate the median home values of every home in every county in America, which would be lower. In addition to that, the formula for FHA financing would drop from 125 percent of median value to 115 percent, which would have a double impact on reducing available credit for the FHA program nationwide. And this is not about high-cost markets. This is about every county across the Nation that would suddenly have a reduced access to home ownership. We are not talking about wealthy millionaires. We are talking about the average American family's ability to access and finance a home in today's world given the complete absence of other capital.

So it is for this reason that not only for FHA but for the GSEs as well, the absence of capital and the needed availability of liquidity that this Administration does support an extension for another year.

Chairman DODD. Well, isn't there the added problem as well that you actually then—you are driving home prices down, therefore reducing the amount of equity that people may have accumulated in their home, thus reducing the wealth creation. Isn't that also——

Mr. STEVENS. Absolutely. The secondary effect is absolutely as you say, Senator, that it will lower—lack of access means less available buyers, which means more inventory on the market, which will depress home values potentially even further. And it is for all those reasons that we recommend that we do an extension responsibly for another year, giving this market a chance to complete the healing process and begin to regain its necessary recovery.

Chairman DODD. I have not had a chance to talk to my friend and colleague Richard Shelby, but I would hope my colleagues would take a look at this in the next 2 weeks. Whether or not we can include something like this as part of the CR could be very important. And I would just ask them to pay attention to it and give me your advice and counsel on it as well.

Mr. Scirè raised the issue of having a legislatively mandated time line. We legislatively mandated the 2 percent. There is a certain attractiveness to that, but I think you may have—in fact, I identified one of the potential problems, which is the question I would like to raise with you, Mr. Scirè, and that is the potentially countercyclical feature of having a legislatively imposed time line.

Are you concerned that a time line might tie the Department's hands, undermine the FHA's ability to do its job at exactly the time when we may want them to be more aggressive in moving these areas? Clearly, the program seems to be restoring the program's capital without a time line. And do you believe that such a time line is needed? And let me ask you, Mr. Stevens, that as well.

So give me the potential problem of the counter—the procyclical nature. Excuse me.

Mr. SCIRÈ. Well, you saw that we were very careful in our recommendation——

Chairman DODD. I know.

Mr. SCIRÈ. ——because FHA obviously has some competing goals. And what we think is that this is an excellent opportunity for the Congress to weigh in on and to give direction to FHA as to where that balance should be between financial soundness and its role in supporting the mortgage market. So I think that that is where we would leave that.

Chairman DODD. Well, is it overkill a little——

Mr. SCIRÈ. There is another advantage to——

Chairman DODD. If you are moving in the right direction on these things and doing what needs to be done and the reforms that are necessary, does a legislatively imposed time line to achieve that—and it seems to sort of disregard other factors that may be occurring out there that could contribute to that kind of a decision and thus make it more procyclical. That is my point.

Mr. SCIRÈ. Well, I do not disagree that a time line, a too advanced time line would be counterproductive given where we are in the market today. So that is why it is important to consider what role you expect of FHA in the next few years or whatever amount of time you think makes sense to get back to a 2-percent ratio.

What it does provide for you is a means for holding FHA accountable, and so, you know, one of the things that you might expect here is for FHA to lay out what it thinks might be a reasonable timeframe for achieving a 2-percent capital ratio while meeting its——

Chairman DODD. Well, let us ask the man right here, the man we have at the table. Mr. Stevens, how do you respond to that?

Mr. STEVENS. I respond in two ways. One, I believe a time line would be the wrong way of approaching the FHA reform, and just to be very clear, the National Housing Act does not say the Secretary can, if he wants to. It is "the Secretary shall" do everything in his authority to get the capital reserves back above 2 percent.

As you can tell by the actions that I have reviewed today, we have done the most aggressive, sweeping set of reforms to get the FHA capital return to above 2 percent, and those steps are in process.

I do agree with at least some of the tenor of the points that you have made, that if you put a time line in place, it could force actions that could have broader adverse impacts to the markets. And so it is those unintended impacts that could ultimately be of concern.

The other variable which I think is important is any forecast against an actuarial reserve is highly dependent on home price expectations. The HPI is the single biggest determinant on how it is going to impact capital on a broad portfolio. Despite all the other credit characteristics, that and our ability to bring in premium are the two biggest drivers we have right now that will ultimately the capital reserve. And so based on last year's forecast, when we submitted and went through the minimum capital reserve results, the actuarial firm had laid out a prospective view on when the capital reserves might return above 2 percent. And at that time, it was between 3 and 4 years. And, you know, at this point we remain committed to believing that that time line can be reached, and a lot of it has to do with our ability to implement the reforms that we have asked of Congress to get into the market so that they can take hold both in increasing premium and helping us hold lenders accountable for loans they should not have originated to indemnify the FHA. It is those kinds of actions that will help us get there. We do believe the time line is a challenge.

Chairman DODD. OK, and others may raise this. One last thing. I have gone over the time, but let me pose just one more because this is one that we debated extensively in the financial reform bill, and that is—and my good friend Bob Corker was, I think, the leading advocate of this, though others were as well. And there is a lot he says that I agree with, and that is, mandating minimum down payment requirements. I believe 5 percent is what we were debating at the time. And I pointed out earlier that the delinquency rates obviously in FHA were not substantially worse than the prime rate area. But, nonetheless, there is an argument for it, but there is also an indication if you have good underwriting standards, mandating a certain minimum down payment requirement may be—would you comment on that? What are your thoughts on that?

Mr. STEVENS. Thank you, Senator——

Chairman DODD. And I apologize to my colleagues. that is the last question I will have.

Mr. STEVENS. I do want to reflect that I bought my first home in Denver, Colorado, in 1970-something with a 3-percent down payment from the FHA with at the time my young bride, and had we not been able to get an FHA loan, we would not have bought a home; neither would thousands of other people in our community and, obviously, many more across the country.

Down payment alone is not the single characteristic that results in default, and as we have all learned through this past period, it is the layering of risk that caused high default rates.

The FHA portfolio is very different. It is all owner-occupied. It is all primary residence. It is all—if you can believe it or not, we fully document every single loan. I know that is a shock to many in the industry. And so the only risk variable ultimately ends up being that 3.5-percent down payment for those borrowers that can qualify.

Even the actuarial firm recognized that the changes that we had recommended to control that risk would eliminate the vast majority of the delinquency attributes that are associated with the portfolio.

Let me give it another way. We show that loans with FICOs under 580 have a worse default rate at below 95 percent than our loans at maximum loan to value, just over 580 to 620. So you can get performance characteristics with a low down payment as long as you control the credit quality standards across the remainder of that spectrum. And so I think our core concern when we established our policies that we implemented was to balance the need to provide available liquidity for home ownership across America, particularly first-time homeowners in underserved markets, which has been core to our mission over time, without creating the unintended consequences of eliminating capital and slowing any recovery in the housing market. And it was those two balancing acts, while looking at the credit characteristics underlying them, that resulted in this two-step approach. Under 580, 10 percent down. Over 580, the performance is clearly different and can support the minimum down payment requirement.

Chairman DODD. Thank you very much.

Senator Shelby, I apologize.

Senator SHELBY. Do you believe, though, that underwriting standards do play a role and should play a role on any loan?

Mr. STEVENS. Yes.

Senator SHELBY. Of course, I know why the minimum down payment. You said you paid 3 percent down. I am sure you didn't default, but I am sure you had good credit and you were going to pay that loan or die. You know, a lot of us would. But underwriting is the key to anything, whether it is bonds, diligence. You do diligence on this. Now, there are some people with bad credit and bad history that could pay 20 percent down on something and they think nothing—you know, if something happened, they would just walk off from the loan and so forth.

But I do believe myself that underwriting is a key to a lot of this, a lot of this, period. And what we want, as I understand it, I certainly want a good housing program, but I don't want a welfare program. I mean, that doesn't help anybody in the long run. It makes you not viable down the road.

And speaking of that, how are you going to grow to at least have that 2 percent and when is that? You don't want a statutory framework, but what do you want?

Mr. STEVENS. Senator, as I said earlier, and these are complex answers because there are obviously economic variables, I can take an existing economic scenario and say, if that scenario holds true, our capital would return to a level by X period.

Senator SHELBY. You are speaking of the economy as a whole?

Mr. STEVENS. I am talking specifically more about——

Senator SHELBY. And unemployment and all this, people having a few dollars?

Mr. STEVENS. Yes. The big drivers are going to be the home price index. It is going to be the discount rates in the market and it is going to be recovery rates or what we recover on defaulted loans. Those are going to be some of the major drivers that will ultimately allow us to run a formulaic process that allows us to determine precisely when the capital gets back. That was done in the last actuarial, and the one we will submit to you in November, again, we will have an expectation—the independent actuarial firm will have an expectation of when that capital should get above 2 percent.

There is no doubt that the premium authority you just granted us will add at current run rates an additional $300 million a month in premium, which will allow us to build faster had you not given us that authority. So it is those kinds of changes that will get us there and we will forecast that for you, again, in the upcoming actuarial review, which ends at the end of the fiscal year.

Senator SHELBY. What is it going to take financially for a lot of us not to be concerned about FHA, just as we go back 10 years ago, close to it——

Mr. STEVENS. Yes.

Senator SHELBY. ——we were really concerned about Freddie Mac and Fannie Mae.

Mr. STEVENS. Senator——

Senator SHELBY. A lot of us are concerned about FHA, and you know why.

Mr. STEVENS. Yes.

Senator SHELBY. What is it going to take to allay these concerns?

Mr. STEVENS. Senator, I think we all should have a concern about FHA. I think it is the only responsible way——

Senator SHELBY. You are the Commissioner, so it is right in your lap.

Mr. STEVENS. ——and I am concerned about it, and as you may recall, when I testified in front of this Committee for my nomination hearing, I stated at the time that I believed FHA was being adversely selected in the markets, and we have the 2006, 2007, and 2008 portfolios are terrible books that were allowed to be originated with relatively limited scrutiny by those involved, and we are going to be paying the price on those loans for many years to come. And if home prices flatten or recover, the strength of the fund will grow quicker. If home prices recede and worsen, depending on that pace, that will make the recovery much slower.

But I will tell you, I remain extremely concerned about it. I have my Chief Risk Officer here with me today. It is what he spends the vast majority of his time focused on. And I think we will both feel comfortable probably around the same time. At this point, the aggressive actions we are taking and the results we are seeing, even in the third quarter report we just submitted to all of you, is clearly a reflection that what we are doing is having an impact.

But we are absolutely not out of the woods and we retain the same level of concern, I believe, that it would only be responsible and that you would want us to have.

Senator SHELBY. Of the FHA portfolio, roughly what percentage are underwater right now? It has got to be growing, and high.

Mr. STEVENS. The general consensus of economists, the Mark Zandis of the world, *et al.,* are that roughly 20 to 25 percent of all loans in America have negative equity. Now, they are concentrated——

Senator SHELBY. What about FHA, though?

Mr. STEVENS. It is going to be less dramatic simply because our concentration, we are not——

Senator SHELBY. What does less dramatic mean?

Mr. STEVENS. I don't have a precise number for you——

Senator SHELBY. It would be high, though, would it not?

Mr. STEVENS. It would definitely—it is high for all portfolios and would be high for the FHA.

Senator SHELBY. Is this the highest in the history of FHA?

Mr. STEVENS. We have not done the analysis, Senator, to see——

Senator SHELBY. Can you go back and do the analysis, say, for the last 20 years and furnish that to the Committee and see where FHA was in 1990——

Mr. STEVENS. Sure.

Senator SHELBY. ——2000, 2005, you know, all this——

Mr. STEVENS. Yes.

Senator SHELBY. ——because we would like to know.

Mr. STEVENS. Yes, and——

Senator SHELBY. We want you to survive.

Mr. STEVENS. And Senator——

Senator SHELBY. If we don't have the information, we don't want to be shocked like we have been before.

Mr. STEVENS. I completely agree, and the ability to be transparent——

Senator SHELBY. Are you going to furnish that information and get it to the Committee?

Mr. STEVENS. We will furnish you our best estimate of what that number is.

Senator SHELBY. Now, wait a minute. We don't want your judgment. We want statistics. You can go back and see. You have got to have data on the percentage of loans, say, in 2000, 2005 out there, how many foreclosures, how many underwater, and all this. You keep up with that. You have to. If you don't keep up with it, you are in trouble.

Mr. STEVENS. We do benchmark appraised values across the country and we use a home price index——

Senator SHELBY. By "benchmark," what does that mean to FHA?

Mr. STEVENS. You can't—it would be an extraordinary project to take six million loans in every community across the Nation and reappraise every one of them based on today's values.

Senator SHELBY. Well, I am not talking about that. I am saying, how many people are underwater today? How many pending possible foreclosures do you have? It has got to be high, and we need to know, because I think that goes to the bottom line of what GAO is talking about.

Mr. STEVENS. We will report to you our pending foreclosures. Underwater is based on negative equity. It requires an estimation of the existing value of the property, of which we have about six million loans across the country. We can do that by looking at market areas against local home price indexes that we use. We will go through that process.

Senator SHELBY. Would you call those hard numbers? Would they be hard numbers? We are looking at hard numbers.

Mr. STEVENS. They will be the best numbers that we can discern. I would encourage the GAO and others to take a look at them and come up with their best estimates, as well.

Senator SHELBY. In other words, if somebody was going to buy your portfolio, they would be looking at what was really in that portfolio——

Mr. STEVENS. They would use the——

Senator SHELBY. ——what was performing, what was not performing, what was——

Mr. STEVENS. Right.

Senator SHELBY. ——shaky, right?

Mr. STEVENS. And, Senator, they would use the same methodology that we will embark on.

Senator SHELBY. And you are going to furnish this information to the Committee?

Mr. STEVENS. We will furnish that to the Committee, yes, sir.

Senator SHELBY. Can you do this in the next month or so? You should be able to do that.

Mr. STEVENS. We will do our best.

Senator SHELBY. I have got to ask, Mr. Scirè, are you skeptical, real skeptical, doubtful that FHA is going to get toward that 2 percent, just 2 percent, goal?

Mr. SCIRÈ. I don't think we have any way of knowing when FHA will get to the 2 percent. FHA actually is in the best position to do that estimate, and so I would expect that it would be able to say, with the policy changes it has enacted, with the ones it is contemplating, using its modeling, and this does involve assumptions about future economic activity, but they should be able to tell us what their expectations are about getting to a 2-percent ratio.

Senator SHELBY. What is your judgment today on the financial condition of FHA? For the record here and before this Committee.

Mr. SCIRÈ. Right.

Senator SHELBY. Honestly——

Mr. SCIRÈ. Well, today, where the capital reserve account is down to a $3.5 billion level——

Senator SHELBY. Isn't that a dangerous level?

Mr. SCIRÈ. Well, it doesn't leave much of a cushion.

Senator SHELBY. That is right.

Mr. SCIRÈ. So what will be really interesting to see is over the next month or two, as the FHA receives the results of this year's independent actuarial review, whether or not the changes and expectations for future house prices or interest rates, how that affects what their estimate will be for the fund and how that might trickle down to or reflect in that capital reserve account come next year.

So I am very curious to see the results of this year's actuarial review, and again, these estimates are based on expectations going out 30 years and are highly dependent on expectations for house prices and interest rates, so they can move around quite a bit.

Senator SHELBY. Thank you. Thanks, Mr. Chairman.

Chairman DODD. Thank you very, very much.

Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, gentlemen, for your testimony today.

Mr. Stevens, you noted that you made some significant and important changes, a risk officer, I understand the FICO scores for your applicants have gone up significantly, that you have got a much better book this year of loans than you had when you stepped into office, and that is positive.

But one of the issues that is affecting all the questions we ask today is foreclosure rates. If they continue to accelerate, then the value of the portfolio goes down. Your ability to reach the 2 percent capital level is further put off. And there are some provisions that are involved with FHA mortgages that allow some mitigation tools, and let me ask you, are you taking specific steps to ensure that homeowners understand if they have FHA insurance that there is a full range of FHA loss mitigation tools and reducing these foreclosures?

We are hearing that services, mortgage services or mortgage holders are not telling people potentially into default or on the edge that they have these mitigation techniques. What are you doing to make sure they know what their rights are?

Mr. STEVENS. I appreciate that question and it is clearly of critical concern to us. There are a couple of things in place. First of all, the Protecting Tenants from Foreclosure Act requires that the consumer be notified that it is an FHA loan. We require it of all servicers to notify their borrower if it is an FHA mortgage. There are a couple of additional steps that we mandate, which is required of every servicer in the FHA portfolio, is they must engage in the loss mitigation requirements of FHA in the early period of default for every consumer. I believe that in past periods, there was less monitoring of servicer compliance with that.

We have instituted a very robust set of servicing reporting, which we review monthly, to look at exactly how they are engaging in loss mitigation on their portfolio and what percent of their portfolio they are in compliance on. There are outliers. There are outliers amongst some of the larger servicers and we are working very aggressively with them and we will take further actions to extend our ability punitively to make sure that they comply with that policy.

But we completely share—I completely share the concern about making sure every homeowner is protected with every right available to them, particularly in the FHA portfolio.

Senator REED. One of the particular tools that you have available is the occupied conveyance, which essentially allows someone to stay in the property even though legally they have lost title to the property. Are you using this tool, and if you are, how aggressively effectively are you using it?

Mr. STEVENS. We use the occupied conveyance tool primarily for people who are in the property, and most often in times of illness or some severe situation where the Secretary deems that they should be protected and we provide for the occupied conveyancy. We do have a much broader set of loss mitigation tools, Senator, that can provide a number of solutions to keep people in their homes. Quite frankly, it is the broadest set of loss mitigation standards that I have ever seen in sort of an investor portfolio that is available to keep people in their homes.

We have not broadened the occupied conveyance standard at this time. To do so could add some significant expense and could be extremely problematic. I would be glad to submit some further information to you if you want some further clarification of that.

Senator REED. Thank you. One issue here, just a general comment, perhaps, is that you are also attempting to marginalize the technology of FHA.

Mr. STEVENS. Yes.

Senator REED. We had these discussions with your predecessor, who—one of the reasons I think you couldn't accurately assess risk and control your risk was you had no idea what was going on because of technological gaps. How well are you doing in that regard?

Mr. STEVENS. So there are two sides to that question. The first is we do have a number of tools that have been available without technology, and I want to make clear that upon being sworn in, I established a very specific set of protocols including very deliberate monthly reporting in detail of performance of our total portfolio, and this set of robust reporting is now being managed by the Chief

Risk Officer and it allows us to have much more data than perhaps previous Administrations took the opportunity to engage and look at. So I do think that there is a lot of data available.

That being said, we do need enhancements. We have implemented and actually awarded the first three contracts which on our first focus area was risk and fraud, and we awarded our most recent, the third contract, just a few days ago to completely upgrade our ability to establish automated risk and fraud tools which will enable us to catch fraudulent transactions very early on in the process, something that FHA did not previously have the ability to do. The rest is—a lot of funding will come in the 2011 budget. In that, we will implement new capabilities as the funds come to us according to our plan that we submitted to Congress.

Senator REED. The current level of insurance, the maximum is $729,750. That will expire at the end of this year. What is your position with respect to extension?

Mr. STEVENS. As I said earlier, first of all, the Administration supports extending all the limits for another year. I do want to make clear, with FHA, we do very few loans at that limit, but it is more around—the formula would also expire and it would affect hundreds of counties across the Nation that would now have their loan limits reduced, even for lower sort of median-income homes if we were to not extend the formula.

Senator REED. Very good. And a quick question to Mr. Scirè. In terms of your recommendations, the modeling of FHA, the fund, is being done now by contractors. You are recommending a slightly different approach that you feel would be more accurate in assessing capital levels, and again, one of the key questions around here is when do we get to 2 percent. You are suggesting perhaps if we measure it differently, we might be closer to it or further away. Can you just very briefly, because my time is expired, comment on what your advice would be?

Mr. SCIRÈ. Our recommendation is that FHA move away from using a single economic scenario for estimating the value of the fund for the purposes of compliance with the 2 percent, and the reason we recommend that is that it would tend to overstate cashflows. And so stochastic simulation is what we are recommending. It is a widely accepted practice. FHA itself recognizes the utility of it in terms of—or the usefulness of looking at many scenarios in terms of its stress scenarios that it does. But it is not used for purposes of compliance with the 2 percent. So we think that that is a direction that it needs to take.

Senator REED. Your comments, quickly, Mr. Stevens.

Mr. STEVENS. So first of all, we agree with the GAO's recommendation. The new contract for our next actuarial review will include stochastic modeling. I do want to emphasize that we run multiple paths on a deterministic approach, which is how most of the analytics on our portfolio have been done by other agencies, as well, but we do believe the stochastic modeling is the right way to go.

Senator REED. Thank you gentlemen very much. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and I appreciate you having this hearing. I know that this will be the next topic, housing finance in general, that we all wrestle with, and certainly appreciate the witnesses ending this year with this kind of testimony.

It seems to me, Mr. Stevens, at the FHA that what is happening right now is we have had a down market. You had a series of sort of bad vintage loans that you were dealing with when you came in, and that what you are in essence doing is not unlike what happens many times in the private sector when there is a downturn. You are sort of building through this and building volume and hoping that as things stabilize with this large volume of new loans, that you end up back at the capital requirements you need to have. Would that be a good summation of what you are doing?

Mr. STEVENS. I would say—if you don't mind, I would clarify that. We are not just hoping to get back there by building volume. We are raising premiums, and one of the most significant ways that we can address the existing bad books, outside of just building volume with better quality loans at higher premiums, is to have the ability to require indemnification from the lenders based on things beyond just fraud and misrepresentation. If they originated a loan outside of our policy guidelines and it wasn't fraud or misrepresentation, we have had limited capability to go after them and not pay their claim, and make them pay the claim.

That is the way we could protect the balance sheet on even the past book years. That is actually in the FHA reform bill, and that is why we are very hopeful that Congress and the Senate particularly will not only introduce that, but get it passed so that we can hold the lenders accountable. That will actually strengthen the fund because we won't pay claims on some of the bad loans from the old books as we look at it.

Senator CORKER. In preparation for this next debate with GSEs and all of that, we spent a lot of time with the analysts over the last several weeks. Numbers of them are saying that with the volume that we have out there of unoccupied homes or homes for sale—I think there are about two million of them—that it is likely that over the next 6 months, that housing prices will continue to decline before things start increasing. What kind of models are you all using internally?

Mr. STEVENS. We do look at the same relative forecasts that any economist that you and your staffs would be consulting with, as well, and we are seeing a series of forecast expectations that range from sort of a relatively flat environment to perhaps significant softness, particularly in some key market areas. And without question, the core point there is absolutely accurate, that the additional softening of any markets will clearly add incremental risk to portfolios and stress to the general housing recovery.

The question is, if home values are going to drop, will it be broad-based nationally or will it be regionally or in select areas? What is the net impact to those particular areas that may be impacted? And then what kind of controls do you put in place? And more importantly, what kind of solutions do we think about to try to put in place to try to stabilize those markets?

This is clearly the worst housing market any of us have ever lived through in our professional lives, and so attacking this in a very methodical but thoughtful way is extremely important at this time.

Senator CORKER. So the Chairman mentioned in his comments about extending the limit, the upper limit right now on FHA loans, and as a beginning point, that is something that is not particularly interesting to me. On the other hand, you did mention something about the formula and how the fact is that only 3 percent of your loans are above the normal limits, but the formula is the part that is important.

So along the line of questioning that has gotten me in trouble multiple times in the past, is there a way to deal with the problem you have without actually raising that limit? In other words, I think most of us want to see—I think everybody actually wants to see the involvement that Government has in guaranteeing loans decrease. I think everybody here does. Is there a way to address the issue that you are talking about and still go ahead and drop down to the norm and somehow keep the formula in place, because you are only affecting, again, 3 percent of the loans that you are actually originating today or insuring?

Mr. STEVENS. Senator, I think there would be a variety of ways to respond to the concern about FHA being able to provide ongoing financing for really the vast majority of the homeowners outside of the limit. Here would be my less than sophisticated response. We are under a very tight timeframe. Lenders already today are beginning to think about pricing for January loans and they are going to begin cutting back opportunity, home ownership opportunity, refinance opportunity, across the Nation here in just the next few short weeks.

Considering the fact that the actual use of the higher loan limits is really not pervasive in the FHA portfolio, and quite frankly, the performance on them is very good, even though it is less than 3 percent of the portfolio, it is not a real impact driver, our recommendation is to simply extend the limits for another year.

But I do share your concern, and I know we have spoken about it beyond this. The role of the U.S. Government in the housing finance system has got to pull back, particularly FHA, and there has to be a way for private capital to reengage. My discussions with private investors is they don't have an appetite for mortgages in this country to begin with, so even if we pulled back, there is no clear evidence there would be enough capital to support this housing system. So all those reasons combined that I just reviewed are why we recommend a simple extension for 1 more year rather than doing too much fine-tuning that could get lost in debate when it really is not particularly relevant to risk in the FHA portfolio.

Senator CORKER. Well, it just seems to me that it would be relatively simple for you all to—I mean, we are not going to do a lot of fine-tuning. We take recommendations from folks like you and look at them. It just seems to me there would be a way of accomplishing exactly what the Chairman laid out, and that is keeping the mortgage market operating, and if it is not really dealing with those larger loans, we could also as a Congress be taking a step back to the norm, which I think is also important. That is another important thing, I think, for the economy to sort of get back to the norm.

I know my time is up, but it doesn't seem to me it is that difficult to do some of that fine-tuning you are talking about. All we would do is say yea or nay. We wouldn't be fine-tuning it ourselves, and I hope that—I know my time is up—that we could talk just a little bit more. It seems like there—or maybe is there a way to say that, look, you can't do more than 3 percent?

Mr. STEVENS. We have had these discussions before about controlling the mix of FHA loans. I think that is a difficult approach to getting at it. I would be glad to follow up with you on that particular item. But again, our view at this time is that, over time, these temporary extensions need to ease back when there is private capital returning. At this time, given the limited impact of any loans in that area to begin with, the fact that it probably has some meaningful value in some of the real high-cost markets, even though it is not a meaningful value to the FHA portfolio broadly, and the very short timeframe that we have to respond right now and the increase in anxiety that is occurring across this broad housing finance market with all the participants, we continue to recommend that we do the extension for a year, but I would be glad to follow up and have a conversation with you about it.

Senator CORKER. Mr. Chairman, I thank you. I guess my only concern in closing is we end up with these things like SGR that never go away, AMT fixes that never go away. I think if there is a way you could help us, we understand the problem and I am very sensitive to the problem, but at the same time, I think we are getting into a territory which makes this a permanent extension forever and I hope you can help us think through another way. Thank you.

Chairman DODD. I appreciate Senator Corker's questioning, as well, and obviously, I think we are all trying to get the same result. I just would note before turning to my two colleagues, I believe, and this won't come as any great shock, obviously, but the realtors and others who are all coalescing around this idea of the extension as they see the problem, I think one of the major points you made is that there is so much in the housing market that is based on anticipation. No one knows this better than my colleague from Tennessee, having lived in this world, that that point you made about January, and while this is—I don't think most people recognize how much of that market depends upon that idea. And so that is the quandary, in a sense, we are in.

So anyway, we will talk about it and I will talk to Senator Corker, as well, and hear any ideas on this as we go forward. I would like to be able to get a consensus, obviously. If we end up with a brouhaha on the floor of the Senate, that is not going to happen, so we need to figure out some way to get this, do this in a way that makes some sense.

I was going to make the point—I am going to turn to Senator Merkley, but I wanted to make a point. When you mentioned Senator Brown and Senator Begich, the lead cosponsor on this FHA reform bill is Senator Bennet of Colorado, as well, and I wanted to make sure the record reflected that my colleague from Colorado is a lead advocate of that reform bill.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you all for your testimony.

Commissioner, when you were talking about modeling risk, you mentioned, I believe, that home prices are the biggest driver. I assume that is because if home prices go down, more people walk away from their homes and also the recovery rate is lower, so it hits you on both ends. Is that kind of the correct——

Mr. STEVENS. That is correct.

Senator MERKLEY. As you kind of test the boundaries of risk in that area, are there any scary numbers we should be aware of? For example, if home prices go down another 5 percent over the next 2 years, is the insurance fund bankrupt?

Mr. STEVENS. If it would be permissible, I would like to follow up with the Committee on two points. In the last actuarial review, we actually did testing on worsening home prices, and we will do it again when we submit the actuarial to you in November. It will show the prime path, but it will also show worst scenarios assuming deeper HPI recessions and it will show how that impacts the capital.

So it is a concern and there are variances in those scenarios. But without giving an off-the-cuff response, if it would be permissible, I would like to give you more thoughtful feedback on how that——

Senator MERKLEY. Absolutely. I would appreciate that. And I recognize that, essentially, these parameters are being applied to loans that were not originated, if you will, under your leadership, which brings me to the next topic, which is the subprime default rate under the FHA portfolio is really pretty shocking when we compare that to more conventional loans, and I am assuming that is a combination of factors, that a lot of these loans were liar loans, that a lot of these loans involved a 2-year teaser rate that popped up to a much higher level and people can't get out of them because of the prepayment penalties, and that a lot of people were steered into these loans when they actually qualified for a prime loan. I think the *Wall Street Journal* showed 60 percent of the subprime mortgage holders qualified for a prime loan.

And so in 2010, there were still a lot of Alt-A loans that were scheduled to essentially hit the point at which families would be triggered from the lowest of the three payment options to the highest because they would max out their negative equity limits. Have we now worked our way through the vast bulk of triggers, if you will, that drive to higher payments and therefore trigger essentially default?

Mr. STEVENS. So there are a couple of variables that I think will be big trigger points that we are looking at. One of them, we have already passed through for the most part, and that was the 228 subprime spike, as it were, which caused an interest rate adjustment at the end of the second year, and that is why I think in the early phase of this default challenge we went through in this country, we saw the subprimes defaulting at a much higher rate in the early period. Now that seems to be moving to other potential product types and it began to evolve.

One of the classic cases is this thing called the pay option ARM, which many of you are familiar with, that started with a very low initial teaser rate but then would escalate up over time. The challenge with those loans is they originated over multiple years and there are two triggers that will cause an adjustment. One is they either have a fifth or 10-year, some of them, a 10-year adjustment, that if a loan won't pay off over the remaining term, they do an automatic adjustment. We will see those come in in quantities over the next couple of years as we see this market move through, assuming no other recovery in sort of general home prices or perhaps on the employment side to help these borrowers stay in the home and pay them.

I will add one other point, is these loans are held primarily on three large bank portfolios and the banks are also aggressively working with these loans and doing things outside of the contract itself to try to keep the people in the homes and offering them a variety of other options, whether it be the HAMP program that we provide or their own internal modification program. All that said, I think we still have a ways to go as we work through that portfolio and the markets in general.

Senator MERKLEY. So you feel like your modeling has a pretty accurate reflection of the types of loans, the way in which they ripen, so that we have got our hands around the dimensions of the challenge?

Mr. STEVENS. Yes. That data clearly exists and it is being reviewed by members at Treasury, National Economic Council, and here at HUD, and we talk through those numbers, what the products underlying are. We talk to servicers about what they are doing to address them and what the experience is. We go to anybody, economists particularly, who can help us look at reasonable analytics on the portfolio. So all of that is being done.

Senator MERKLEY. Well, this brings me to the next piece, which is specifically to ask about the yield-spread premium rules, or the steering payments, if you will. The Fed has put rules—well, they haven't put them in place yet, but April 2011 they go into effect. The Dodd-Frank bill severely restricts the use of such steering payments. But does it make sense not to wait for those both to go into effect downstream and to apply kind of strict yield-spread premium rules now for loans being originated and being insured by FHA?

Mr. STEVENS. Senator, it is an important question and we are looking at that right now. We are looking at the implementation of the Dodd-Frank bill across a variety of parameters that exist in the FHA portfolio.

It is interesting that the FHA loans are a little different in that it is sort of one product type. There is little opportunity to sort of game our system from that standpoint simply because every loan is a 30-year fixed-rate loan, fully documented, sort of vanilla, as it were, type of product. And so you don't have the optionality that loan originators can do with other programs that are less easily understood by consumers.

That being said, we are looking at it and I will be glad to report back to you in terms of our timing and what we can do and implement in the early phase here.

Senator MERKLEY. Yes. So essentially, you are no longer insuring subprimes and therefore there aren't really bonuses connected to steering people into subprimes?

Mr. STEVENS. Right.

Senator MERKLEY. OK.

Mr. STEVENS. Well, and add to that, Senator, FHA never did subprime. FHA was always doing 30-year fixed rate mortgages and there were no 228s or that kind of product. We did have much lower credit quality in those past book years, some of which people compared to the same sort of credit scores as subprime borrowers, but the product itself was a 30-year fully amortizing fixed rate during that period.

Senator MERKLEY. So when I see this analysis of the FHA portfolio and I am seeing default rates of 30-plus percent on the subprime component of the FHA inventory, those aren't actually subprimes?

Mr. STEVENS. That is actually a comparison of our portfolio against how a subprime portfolio performs.

Chairman DODD. Delinquencies in the FHA were 9.4 percent.

Mr. STEVENS. Right.

Chairman DODD. Prime rate was about 7 percent. And subprime, which was never part of FHA, was 30.6.

Mr. STEVENS. But that particular table is designed to highlight the fact that Senator Dodd just emphasized, is that we aren't really a subprime portfolio, and by showing subprime delinquencies, it allows us to create that distinction between the two books.

Senator MERKLEY. I see. Well, that helps explain, because I thought you had insured some subprimes. I misinterpreted this chart, because this chart is labeled, "Characteristics of FHA Insured Mortgages," and then it shows subprimes.

Chairman DODD. That is what they have been trying to do for a long time, and that was the point I made this morning, that it really is closer to the prime rate. Actually, it was much better.

Mr. STEVENS. I apologize for creating that confusion. That is our fault. We will relabel that chart so it is clear. These are complex data charts. That is really our fault and we shouldn't do that, because we deal in an esoteric world and you shouldn't have to try to figure that piece out.

Senator MERKLEY. I have so many more questions for you, but I see I am over my time.

Mr. STEVENS. I am always available to you, Senator.

Senator MERKLEY. Thank you.

Chairman DODD. Thanks, Senator, very much.

Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman. Thank you for holding the hearing. And, Mr. Stevens, we certainly will take you back in Denver, Colorado, whenever you want to come. But in the meantime, you are doing important work here that I want to congratulate you on.

I want to underscore something Senator Merkley said and you have heard here. The interest, I think, in this Committee about being able to see the stress testing you are doing of the models I think springs from a sense among some of us that the oversight here was not so good either. And the idea that, you know, we were—not we, FHA and others were running loan portfolios without actually knowing what the underlying risks were, then Congress was not doing the oversight it should have been doing, leads us to want to learn from that and do a much better job. So I also would be very interested to see the product of your work.

I wanted to ask you a few specific things. As the Chairman mentioned, I am cosponsoring the reform legislation that you have talked about today. In your testimony, the written testimony, you mention that FHA currently can only seek indemnification from 29 percent of its approved lenders in cases of fraud and improper loan origination. The new reform legislation would enable you to seek indemnification from any of the lenders in such cases.

I wonder if you could talk a little bit about what you think that new authority could do for FHA's overall financial strength.

Mr. STEVENS. Senator, we have two designations for lenders within the FHA portfolio. LI lenders, which really are the largest lender insurance providers within our portfolio, the major banks. We have another designation called direct endorsement, DE lenders. These are often smaller institutions, historically have been less well capitalized. And, quite frankly, I think the oversight of them has not been as strong as it otherwise could have been.

Broadly across the country, these institutions originated a lot of loans over the past few years, and as we said earlier, particularly in 2006 through 2008, after the collapse of Alt-A and subprime, a lot of rogue originators came to originate FHA loans without the scrutiny that should have necessarily been there.

Our ability to get the enhancement to our authority to be able to require indemnification of DE lenders will go beyond fraud and misrepresentation. It will go to just loans that were manufacturing quality, as we call it, loans that were underwritten, insured, but they did not meet actually our qualifying guidelines. And under those scenarios, we actually have very limited authority to go back to these direct endorsement lenders and says, "Guys, we are not paying your claim when the loan goes bad. You are paying it out of your own capital."

To quantify what we will be able to get out of it has been a challenge for us because, as we all know through this collapse of the market broadly in the housing system, many of these lenders have gone out of business. Many of them did not have enough capital to be in the business anyway. I have shut down 1,500 in the last year alone. I think the biggest year in history was in the 1930s or something like this. We have gone after this problem very aggressively. But it will allow us to at least go after the remaining companies, of which there are still many, that originated loans, that we can hold them accountable for loans that were outside of our policy and make them pay the claim. The quantity of that will become known once we start requiring them to pay claims to see if they have the money to actually pay them.

Senator BENNET. Do you have a sense of the order of magnitude—was it 2006 through 2008? Is that the period that you are talking about?—order of magnitude what percentage of the portfolio would fall into that category, looking at it retrospectively?

Mr. STEVENS. Yes, let me give you just a couple of examples. Seller-funded down payment assistance loans, which were—I will not go through the program in depth but——

Senator BENNET. The name says it all.

Mr. STEVENS. It is about 8 percent of the portfolio but 20 percent of our defaults. Credit scores less than 580, which, as you know, is where we have drawn our new line, it is about 7 percent of our portfolio but 22 percent of the defaults.

The 2006 and 2008 books, just those 2 years, are 20 percent of our insurance but 45 percent of our defaults. So when you accumulate all this data, you know, really about three-quarters of the portfolio are based on those—in terms of our loss expectations, are based on that portfolio of those 2006 through 2008 book years. But, fortunately, you know, the vast majority of our portfolio based on 2009–2010, about half of it now is originated in the most recent year. So we are bringing in better quality to reduce our overall exposure, but our real losses are coming from just these terrible portfolio years where I think lenders—and I was in the private sector at the time—just took unfair advantage of the FHA and, you know, now we are paying the price for that.

Senator BENNET. When you got there, how did you call attention to the folks that were working in the agency? Did this require—do you have the same people doing this work? How do you change the culture of the place?

Mr. STEVENS. Well, it has been a huge culture change, as many of the team that is here with me today will tell you, that we have implemented a significant culture change in the organization to having, you know, a regime of risk reporting, to creating a risk office. I brought in a new general Deputy Assistant Secretary, Joe Smith, who is here with me today. But we also had—the career staff is outstanding at FHA. You know, their analytic skills, their educational pedigree, and their understanding of the portfolio is extremely valuable. It was just a matter of leadership, providing the direction to them to do the work that needed to be done.

Literally my second week on the job, I called a meeting on one lender, Taylor, Bean & Whitaker, and I pulled everybody in, and we did a review on them; and from that meeting, over the next few weeks on the job, before I had done anything, we went after changes to our streamlined refinance program and minimum capital standards that I wanted to implement. And I just sort of went at it very aggressively from the onshoot in a way that was in an effort to utilize the resources of the organization. The whole team is behind it and the support from the career staff as well as the new team I brought in collectively, we have had a big impact on the organization.

Senator BENNET. Well, I want to thank you for all that. My time is up, and I look forward to working with you on pushing this reform legislation through.

Mr. STEVENS. Thank you, Senator.

Senator SCHUMER [presiding]. Well, thank you, Senator Bennet, and as the Acting Chair, I recognize Mr. Schumer.

[Laughter.]

**STATEMENT OF SENATOR CHARLES E. SCHUMER**

Senator SCHUMER. Anyway, I want to thank Chairman Dodd and Ranking Member Shelby for holding today's hearing on the current condition of FHA. I have a brief statement and a question for Mr. Stevens.

FHA, as you know, as we all know, helped stabilize both the single-family and multifamily housing market since the 1930s by insuring mortgages that meet specific eligibility criteria. In recent years, FHA's role has become more important than ever. During the housing boom, their share of the market was so small, some people thought we should get rid of FHA altogether. Now they guarantee almost 30 percent of all mortgages, and it is scary to think of what the housing market might be like if FHA were not around.

But FHA is limited in its ability to help developers construct or to rehabilitate affordable rental housing in many urban areas—this is my focus, multifamily rental housing—where the need for affordable rental housing is the greatest because of the limit on FHA multifamily loans, which is set well below the cost of construction in these areas. Let me give you an example.

In New York City, the average construction cost for a high-rise building—that is defined as 16 stories or taller—is $419,000 per unit. That is more than double the FHA limit. This makes it hard to secure affordable financing for multifamily rental development and rehab.

In New York City alone, there are 14 developments with over 2,000 units. That is a lot of construction jobs and a lot of housing units, and our population is growing. New York has grown from 7 million people in 1990 to 8.5 million, approximately, this census will show. And so we need this.

FHA cannot help because we have tied their hands in a way that is unfair to high-cost areas like New York. Nationwide, there are 51 projects with 11,000 units stalled.

That is why I introduced legislation, along with my colleague from across the Hudson River, Senator Menendez, called the FHA Multifamily Loan Limit Adjustment Act of 2010. A similar bill was championed in the House by Representative Weiner and actually passed the House in June, the contentious, partisan House, by a vote of 406–4 as part of FHA reform.

The bill would provide the Secretary of HUD the authority to designate high-cost areas and extremely high-cost areas for FHA multifamily insurance, increase the loan limits in those areas from $183,000 per unit to $376,000 per unit. It doubles it.

HUD already had had this authority, but only for Alaska, Hawaii, Guam, and the Virgin Islands. Our bill puts places like New York City, Chicago, Los Angeles, and Boston on an equal playing field. It would also increase the premium allowed for construction or rehab of rental high-rise buildings with elevators as compared to buildings without elevators from 10 to 50 percent, in line with the actual difference in construction costs for elevator buildings.

It is important to note my bill would not alter underwriting criteria or weaken taxpayer protections because it requires that FHA economists vet the credit quality of all borrowers before insuring a loan.

The multifamily loan program is completely funded by its own premiums, separate even from FHA's single-family program which has been discussed this morning. And the multifamily program has not experienced nearly the same difficulties as the single-family program. Recent data from HUD shows that default rates are only

2.2 percent multifamily for 2008–09. The program has had a seriously delinquent rate of only 0.3 percent in 2008. The delinquency rate for single-family homes in contrast is 7.9 percent. So actuarially it is in much better shape.

Moreover, the bill would not raise the overall cap on the total amount of multifamily loans FHA can insure, so it does not present any risk to the taxpayer. The bill has been incorporated—and I appreciate this—in a broader set of reforms sponsored by Senator Begich, Senator Brown, and Senator Bennet, the latter two from this Committee. I would like to thank my colleagues for working with me in the reform package.

So my question for you is simple, Mr. Stevens. Would FHA support this bill, my bill, to raise the multifamily loan limits for high-cost areas like New York as part of a broader legislative package sponsored by Senators Begich, Brown, and Bennet. I am not a sponsor because my name does not begin with a "B."

[Laughter.]

Mr. STEVENS. Senator, we absolutely support the higher limit authority for multifamily. Without question, all the points you made are of great concern to us, particularly as we move into a housing economy where home ownership may drop. There is going to be an increased demand in having safe, affordable, accessible rental properties. And to your point, where land costs are high, it becomes very difficult to finance an FHA multifamily property in this country, and that affects about a quarter, roughly, of all our regional office areas that are impacted by having the lower limits today. So we do support it——

Senator SCHUMER. So you support the legislation?

Mr. STEVENS. Absolutely.

Senator SCHUMER. Thank you. And on that happy note, the hearing is adjourned. I thank all of the witnesses.

[Whereupon, at 11:45 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

## PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you, Mr. Chairman. Thank you, Administrator Stevens and Mr. Scirè for testifying today as we examine ways to strengthen the financial condition of FHA and ensure that FHA has the tools to enforce loan requirements and protect taxpayers from fraud and misrepresentation.

FHA serves an important and countercyclical role in our housing market to ensure that mortgages are available to qualified borrowers even in tight credit markets. From 2007 to 2009, the percentage of loans insured by FHA have significantly increased from 3 percent to approximately 30 percent of the market. Demonstrating the importance of FHA is the fact that the percentage of borrowers with credit scores at or above 720 has doubled compared to borrowers in 2007 and 2008. Without FHA, even credit worthy borrowers may not have received loans because of the contraction of available credit in the private market.

While FHA fulfills this role, it is also experiencing the strains in the housing market and larger economy. Congress and the Administration have taken action to provide FHA with new tools to mitigate the impact of the economic downturn through additional loan requirements and greater flexibility for insurance premiums. I look forward to hearing more about how these changes are affecting FHA's balance sheet and what other changes are needed to ensure that FHA can continue to fulfill its mission while also protecting its long term financial stability and the taxpayers.

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## PREPARED STATEMENT OF DAVID H. STEVENS

FEDERAL HOUSING AUTHORITY COMMISSIONER AND ASSISTANT SECRETARY FOR HOUSING, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

SEPTEMBER 23, 2010

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on the progress the Federal Housing Administration has made towards strengthening its financial condition.

As you know, last year we informed Congress of the independent actuary's findings that FHA's secondary reserves had fallen below the required level. Ten months later, while there is still much work to be done, FHA is on a predicted path that will put the agency in a stronger financial position for the future.

Mr. Chairman, last year at this time the independent actuaries predicted that we would draw down $2.6 billion of capital resources over the first three quarters of this year to pay for rising claim expenses. As noted in our third quarter MMI Fund report to Congress, instead of decreasing by $2.6 billion, net income increased by $450 million. Once we add interest earnings to core insurance income, our capital resources grew by $1.3 billion in the first three quarters of this fiscal year. While our actual performance to date has been significantly better than predicted by the actuary, the net budgetary actuals are in-line with projections in the President's Budget that was provided to the Congress in February.

While economic conditions evolve and significant risk and short-term house price volatility remain present, current trends indicate that as a result of the actions taken by the Administration and Congress, we are making progress in strengthening the FHA portfolio and rebuilding our capital reserves.

The positive signs we are seeing are due, in large part, to the numerous reforms put in place and actions the FHA has taken over the last year, including an increase to insurance premiums in April and the suspension or withdrawal of approval for 1,500 lenders from doing business with FHA. This does not yet account for the additional authority to change our annual premium structure passed by Congress that will add an estimated $300 million per month to the FHA fund.

Of course, we remain cautious, and the job is not yet done. With home prices uncertain, our continued vigilance in strengthening both loan quality and performance for future loans is particularly important. To that end, it is important to note that the early performance data of loans insured in FY2009 and 2010 are much stronger than previous years. While FHA is currently playing an important and temporarily elevated role in providing liquidity to the housing market, it is doing so responsibly.

With the remainder of my testimony, I will explain our efforts in greater detail. In particular, I will describe the role FHA is playing in the market, the reforms FHA and the Congress have put in place, the early results these reforms are producing, and why our ability to protect the taxpayer for the future requires Congress to enact the broader, more comprehensive set of reforms we have proposed.

**FHA's Current Role in the Housing Market**

I'd like to take a moment to outline the important countercyclical role FHA has played in our housing market during these difficult economic times. Created by President Franklin Roosevelt in 1934 at a time when housing prices had collapsed, the FHA was designed to provide affordable home ownership options that would keep our mortgage markets afloat during tough times.

Indeed, when the market began its slow collapse 3 years ago, FHA comprised only about 2 to 3 percent of the housing market. But when private capital vanished at the end of 2008, it was the FHA that stepped in—insuring approximately 30 percent of purchases and 20 percent of refinances in the housing market. Since January 2009, the agency has helped nearly 3 million Americans either purchase a home, or refinance into more stable, affordable mortgages. At the same time FHA has also helped more than a half million families at risk of foreclosure through 760,000 loss mitigation actions.

The results of these extraordinary but necessary actions, combined with many others across the Administration, are clear. Home prices began to stabilize. And homeowner equity started growing again in the second quarter of 2009—to date, increasing over a trillion dollars, or close to $14,000 on average for the Nation's nearly 78 million homeowners.

**FHA's Current Financial Condition**

Still, this heightened role comes at a cost. Last November, upon the final completion of FHA's independent actuarial review of fiscal year 2009, we reported to Congress that FHA's secondary reserves had fallen below the required 2 percent level—to 0.53 percent of the total insurance-in-force. Combined with reserves held in the Financing Account, FHA reported that it held more than 4.5 percent of total insurance-in-force in reserves—$31 billion set aside specifically to cover losses over the next 30 years.

The Administration has taken very seriously its responsibility to ensure that FHA is operating on sound financial footing while minimizing risk to taxpayers. Since I took office as FHA Commissioner in July 2009, we have implemented a broad range of actions demonstrating steadfast stewardship of the fund, while carefully ensuring that we continue to serve communities nationwide.

Specifically, over the past year, this Administration has announced and implemented the most sweeping combination of reforms to FHA credit policy, risk management, lender enforcement, and consumer protections in its history. These reforms have strengthened our financial condition and minimized risk to taxpayers as we continue to fulfill our mission.

On behalf of Secretary Donovan and myself, I want to thank both chambers of Congress, and particularly the leadership of you, Chairman Dodd, and Ranking Member Shelby, for the partnership and cooperation exhibited in passing H.R. 5981, which provides FHA the authority to modernize its premium structure. As you know, this authority was granted through unanimous consent in the Senate and passed by voice vote in the House before being signed into law by President Obama on August 11, 2010. FHA has moved quickly to implement a new premium structure, which will take effect on October 4. Similar authority was included in H.R. 5072, the broader FHA reform measure, which passed the House of Representatives in June. While the swift work of Congress has allowed us to implement the premium change, which is important for FHA's ability to generate greater revenues for taxpayers in line with the President's Fiscal Year 2011 Budget proposal, we at HUD remain committed to comprehensive FHA reform which will provide the tools we need to continue our efforts.

As you know, on January 20th of this year, FHA proposed taking a series of administrative steps to mitigate risk and augment the Mutual Mortgage Insurance (MMI) Fund's capital reserves. These proposals included: increasing the mortgage insurance premium (MIP); imposing a firm floor on allowable credit scores; requiring a higher down payment for borrowers with lower credit scores; further tightening the minimum credit score required for borrowers with low down payments; reducing the maximum permissible seller concession to match the industry norm; and implementing a series of significant measures aimed at increasing lender responsibility and enforcement. We have followed through with each of these reforms, which I will discuss in this testimony.

In conjunction with updated down payment and credit score guidelines published on September 3, the changes to FHA's premium structure are projected to result in an additional $4.1 billion in FHA receipts in Fiscal Year 2011.

With the 2010 fiscal year coming to a close, the independent actuary is in the process of completing its annual study and projections of the capital reserve ratio of the FHA MMI Fund. We expect to deliver the finding of this independent study to Congress in November, which will include the official measure of the capital reserve ratio.

In the interim, I am pleased to inform you that tangible, measureable progress is being made to improve loan quality and performance compared to past years. The independent actuary projected that more than 71 percent of FHA's losses over the next 5 years will come not from newly insured loans, but loans already on our existing books when this Administration took office.

Indeed, the early period delinquency rates for FY2009 and FY2010 loans are much lower than the early period delinquency rates for loans insured in FY2007 and FY2008. This improvement suggests that ultimate claim rates on loans endorsed in FY2009 and FY2010 should be markedly better than the ultimate claim rates of loans endorsed in FY2007 and FY2008.

As detailed in FHA's third quarter report to Congress, it was clear that FHA's loan characteristics and financial performance are better than had been forecast in the FY2009 actuarial review.

**Highlights of FY2010 Q3 Report to Congress**

On August 2, FHA delivered its third quarter report to Congress highlighting the status of the single family MMI Fund programs (enclosed in appendix). As mentioned above, FHA has conducted rigorous analytical reviews, established new reporting protocols and procedures, and announced some of the most extensive policy changes in its history. Under the supervision of our new Chief Risk Officer, these changes have been made to better protect the safety and soundness of the MMI Fund while continuing to serve our mission and support the stabilization of the housing market.

As part of our commitment to increased transparency and to provide Congress with better information and data on the performance and operations of the MMI Fund, we enhanced our quarterly report to include the financial status of MMI Fund cash flows, early payment delinquencies and serious delinquency rates.

As I noted earlier, the third quarter report shows that many aspects of the fund are in better shape. Specifically, the amount of cash reserves in the fund is nearly $3 billion higher than forecasted in last year's actuarial report.

There are other positive signs as well. FHA's portfolio shows the average credit score on current insurance endorsements has risen from 634 in 2007 to nearly 700 today. Loan performance, as measured by serious delinquency and early period delinquency rates, has improved significantly, with the first year-over-year decline in new 90-day delinquencies in years. And actual claim payments to date are $3.7 billion lower than had been projected by the independent actuary although this is somewhat offset by lower than projected property recoveries.

**Additional Reforms—Progress to Date**

The two key ways in which we have strengthened FHA fund solvency have been to increase revenues and engage in better risk management. Therefore, we have been focused on restructuring our mortgage insurance premiums and putting in place mechanisms and policies to protect the FHA for the future.

In October of 2009, we hired the first Chief Risk Officer in the organization's history. On July 28, 2010, we received Congressional approval to formally establish this position and create a permanent risk management office within FHA, for which the Risk Officer is now Deputy Assistant Secretary. With this new office and additional staffing, we have begun to expand our capacity to assess financial and operational risk, perform more sophisticated data analysis, and respond to market developments.

Additionally, FHA introduced policy changes and improved lender oversight and enforcement to increase the quality of FHA insured loans. From my first day as FHA Commissioner, I began a thorough review of our loan practices and organizational capacity and gaps. Over the past 12 months we have introduced a number of new policies and taken several steps within our existing authority, all aimed at strengthening the quality of FHA-insured loans while focusing on ways to improve our operations.

In April, we published Final Rule (FR5356-F-02) "Federal Housing Administration: Continuation of FHA Reform—Strengthening Risk Management Through Responsible FHA-Approved Lenders." Most significantly, this rule eliminated FHA approval for loan correspondents and increased net worth requirements for lenders, thereby strengthening FHA's counterparty risk management capabilities.

On April 5 of this year, FHA raised its upfront mortgage insurance premium from 175 basis points to 225 basis points across all FHA product types (purchase, conventional to FHA refinances, and FHA to FHA refinances).

Subsequently, passage of H.R. 5981 granted us the authority to adjust the FHA annual premium. As stated in previous testimony and noted in the proposed budget, once this authority to adjust FHA's annual premium was granted, we would move to lower the upfront premium simultaneously with an increase to the annual premium.

Effective October 4, 2010, FHA will reduce upfront premiums from 225 basis points to 100 basis points and increase the annual premium to 85 basis points from 50 basis points for loans with loan-to-value ratios (LTV) up to and including 95 percent and to 90 basis points from 55 basis points for LTVs above 95 percent.

We are confident this new premium structure is sound policy, more in line with private mortgage insurers' pricing, and will facilitate the return of private capital to the mortgage market. In addition, the estimated value of this change is approximately $300 million per month of additional income to the MMI Fund.

Our Mortgagee Review Board, which I chair, meets monthly and has uncovered numerous violations of FHA origination and underwriting requirements. We have found false certifications and omissions, such as failures to verify the borrower's income and creditworthiness increased mortgagee review board actions. We've suspended some well-known FHA-approved lenders and withdrawn FHA-approval for over 1,500 others. In addition, we imposed over $4.27 million in civil money penalties and administrative payments to noncompliant lenders.

Beyond steeply increasing lender enforcement, we've strengthened credit and risk controls—toughening requirements on our Streamlined Refinance program, making several improvements to the appraisal process and to condominium policies, and publishing a final rule in the Federal Register outlining new down payment and credit score requirements.

Specifically, FHA implemented a "two-step" FICO floor for FHA purchase borrowers, which will reduce both the claim rate on new insurance as well as the loss rate experienced on those claims. A minimum down payment of 10 percent is now required of purchase borrowers with FICO scores below 579, and a minimum down payment of 3.5 percent is required for those with FICO scores at 580 and above. In addition, applicants with credit scores below 500 are no longer eligible for FHA insurance.

Currently, we have a proposed rule in the Federal Register which is in the comment period to reduce the maximum permissible seller concession from its current 6 percent level to 3 percent, which is in line with industry norms. The current level exposes the FHA to excess risk by creating incentives to inflate appraised value. FHA's experience shows that loans with high levels of seller concessions are significantly more likely to go to claim. Experience to date on loans insured from FY2003 to FY2008 suggests that claim rates on high-concession loans are 50 percent higher or more than those on low-concession loans. We anticipate the final rule to be published before the end of this calendar year.

Within our Single Family operations, we have made significant progress in our postendorsement review process. This year we implemented a new algorithm for selecting recently insured loan files for postendorsement technical reviews. This enhancement gives us a more precise way to conduct quality control reviews. Today, loans are selected for review based on a cascade of loan level characteristics that target risk, making our efforts much more effective and efficient.

To address system and staff constraints, we have been working with Congress to increase staff and technical capacity to handle the increased volume and market dynamics we currently face. We are focused on technology modernization and have teams in place working to upgrade our technology systems. We have a long way to go, but we successfully delivered FHA's first comprehensive technology transformation plan to Congress last September, which we have been implementing throughout this year. In addition, we recently awarded contracts to begin upgrading our risk and fraud tools. We are well underway to awarding additional contracts, and we continue to make progress modernizing FHA's technology infrastructure.

Finally, Mr. Chairman, since I arrived in July 2009, we have added 118 net new hires to Housing's payroll, and I have implemented an aggressive training and human capital development plan that includes managerial and technical skill building training as well as on-the-job mentoring.

**Commitment to Comprehensive FHA Reform**

Of course, the job is far from over. As important as the new premium authority established under H.R. 5891 is, Secretary Donovan and I remain committed to comprehensive FHA reform legislation that enhances FHA's lender enforcement capabilities and risk management efforts critical to our ability to monitor lender performance and ensure compliance. As already mentioned, we hope Congress will pass comprehensive FHA legislation before the end of the year.

FHA remains committed to working with Congress to enact the full breadth of reforms introduced in H.R. 5072 and S. 3704, sponsored by Senators Begich and Brown. In addition to provisions strengthening FHA's lender enforcement ability, the legislation also includes technical clarifications that will allow for third party loan originators to close FHA insured loans in their name. This third party provision is particularly important to ensuring that several hundred community banks are able to continue originating FHA loans.

Additionally, HUD is seeking Congressional authority to extend FHA's ability to hold all lenders to the same standard and permit FHA to recoup losses through required indemnification for loans that were improperly originated and for which the error may have impacted the original loan decision, or in which fraud or misrepresentation were involved. FHA currently has this authority for loans originated through the Lender Insured (LI) process, which accounts for 70 percent of FHA loan volume, but only 29 percent of FHA-approved lenders. FHA is asking that Congress grant explicit authority to require indemnification for loans that were improperly originated for the remaining 71 percent of FHA-approved lenders. FHA is simply requesting that Congress permit FHA to hold all lenders to the same standard; FHA is not asking for expansion of authorities beyond those already granted to FHA to oversee lenders participating in the LI program. Moreover, this legislation will enable FHA to prevent lenders who have demonstrated poor performance in one area of the country from engaging in FHA lending nationwide, because it is often only a matter of time before a lender that has shown it is unable or unwilling to engage in prudent lending in one geographic region exhibits the same recklessness and irresponsibility somewhere else.

**Facilitating Our Recovery and Protecting the Taxpayer**

Chairman Dodd and Ranking Member Shelby, as you can see, we have proposed a comprehensive set of reforms to improve loan performance, hold lenders accountable, and increase revenues to the FHA fund, while also ensuring that FHA continues to support the overall recovery of the housing market and fulfill its mission of providing home ownership opportunities for responsible borrowers.

However, shoring up the FHA won't solve all our housing challenges, which is why the Administration is working to produce a more balanced, comprehensive national housing policy that supports home ownership and rental housing alike, providing people with the options they need to make good choices for their families.

Further, as important as the FHA is at this moment, I want to emphasize that the elevated role it is playing is temporary—a bridge to economic recovery helping to ensure that mortgage financing remains available until private capital returns. Thus, while we must remain mindful that qualified, responsible families need the continued ability to purchase a home, the changes and legislative requests that we have announced are crafted to ensure that FHA steps back to facilitate the return of the private sector as soon as possible.

So, Mr. Chairman, while FHA must remain a key source of safe mortgage financing at a critical moment in our country's history, we recognize the risks that we face and the challenges of this temporary expanded role that we play in today's market. The bottom line is this: the loans FHA insures must be safe and self-sustaining over the long-term. With these reforms the Administration is committed to ensuring that they are today—and into the future. We look forward to working with Congress closely on all these issues and hope to gain your support for our legislative requests to further reduce risks to the American taxpayer.

Thank you again for this opportunity to testify. I would be glad to respond to any questions.

**PREPARED STATEMENT OF MATHEW J. SCIRÈ**

DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

SEPTEMBER 23, 2010

**United States Government Accountability Office**

GAO

Testimony

Before the Committee on Banking, Housing, and Urban Affairs, United States Senate

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# MORTGAGE FINANCING

## Financial Condition of FHA's Mutual Mortgage Insurance Fund

Statement of Mathew J. Scirè, Director
Financial Markets and Community Investment

GAO Accountability * Integrity * Reliability

**GAO-10-1066T**

Chairman Dodd, Ranking Member Shelby, and Members of the Committee:

I am pleased to be here to participate in today's hearing on the financial condition of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund (Fund). FHA has helped millions of families purchase homes through its single-family mortgage insurance programs and in recent years, has experienced a dramatic increase in its market role. FHA insures almost all of its single-family mortgages under the Fund, which is reviewed from both an actuarial and budgetary perspective each year.[1] On the basis of an independent actuarial review, FHA reported in November 2009 that the Fund was not meeting the statutory 2 percent capital reserve requirement as of the end of fiscal year 2009, as measured by the Fund's estimated capital ratio—that is, the Fund's economic value divided by the insurance-in-force. Additionally, although the Fund historically has produced budgetary receipts for the federal government, a weakening in the performance of FHA-insured loans has heightened the possibility that FHA will require additional funds to help cover its costs on insurance issued to date.

My statement today is based on a report released yesterday, titled *Mortgage Financing: Opportunities to Enhance Management and Oversight of FHA's Financial Condition*.[2] My statement discusses (1) how estimates of the Fund's capital ratio have changed in recent years and the budgetary implications of changes in the Fund's financial condition; (2) how FHA and its actuarial review contractor evaluate the financial condition of the Fund; (3) the steps FHA has taken to improve the financial condition of the Fund and how the agency has interpreted statutory requirements pertaining to the management of and reporting on the Fund's condition; and (4) changes in the performance and characteristics of FHA-insured mortgages in recent years.[3]

To do this work, we analyzed actuarial reviews of the Fund, federal budget documents, and FHA and industry data. We reviewed pertinent laws and regulations as well as FHA policy changes and regulatory and legislative proposals. Additionally, we interviewed FHA officials, staff from FHA's

[1]In addition, the annual independent audits of FHA's financial statements review the Fund from a financial accounting perspective and provide information used in the actuarial and budgetary reviews of the Fund.

[2]GAO, *Mortgage Financing: Opportunities to Enhance Management and Oversight of FHA's Financial Condition,* GAO-10-827R (Washington, D.C.: Sep. 14, 2010).

[3]Unless otherwise stated, the years shown in this testimony are fiscal years.

actuarial review contractor, and selected housing market researchers. The report includes a detailed description of our scope and methodology.

We conducted this performance audit from September 2009 through September 2010, in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Summary

We found that:

- Recent declines in the Fund's capital ratio to a level below the statutory minimum resulted from a combination of economic and market developments. More pessimistic forecasts of economic conditions increased the number of predicted insurance claims and losses associated with those claims, thereby reducing the Fund's economic value. At the same time, higher demand for FHA-insured mortgages increased FHA's insurance-in-force. The Fund's condition also has worsened from a budgetary perspective. The Fund's capital reserve account holds reserves in excess of those needed to pay for estimated credit subsidy costs and is used to help cover unanticipated increases in those costs. In recent years, balances in this account have fallen dramatically. If the account were to be depleted, FHA would require additional funds to help cover its costs on insurance issued to date.

- FHA and its actuarial review contractor have enhanced their methods for assessing the Fund's financial condition but still are addressing other methodological issues that could affect the reliability of estimates of the Fund's capital ratio. In particular, past reviews have relied on a single economic forecast to produce the estimate of the capital ratio that is used to determine whether the Fund is meeting the 2 percent capital reserve requirement. This approach does not fully account for the variability in future house prices and interest rates that the Fund may face and therefore may tend to overestimate the Fund's economic value. An alternative to the current approach, known as stochastic simulation, involves running simulations of hundreds of different economic paths and offers the prospect of better estimates of the Fund's economic value.

- FHA has implemented or proposed a number of steps to help improve the financial condition of the Fund, including adjustments to its insurance premiums and underwriting policies. However, certain legislative requirements concerning

FHA's administration of the Fund provide limited direction to the agency. For example, statutory provisions do not specify a time frame for restoring the capital ratio to its required minimum level or clearly stipulate the nature of the information FHA should include in quarterly reports to Congress.

- Data on FHA-insured mortgages illustrate the challenges facing the Fund as well as improvement in certain risk factors. As in other segments of the mortgage market, the performance of FHA-insured mortgages deteriorated as the economy weakened and home prices fell in 2008 and 2009. However, in recent years, changes in key loan and borrower characteristics of FHA-insured mortgages suggested some improvement in credit quality at loan origination. FHA is closely monitoring the early performance of the 2009 loan cohort, which will have a major influence on the Fund's financial condition because of its large size, but it is too early to tell whether it will perform to FHA's expectations.

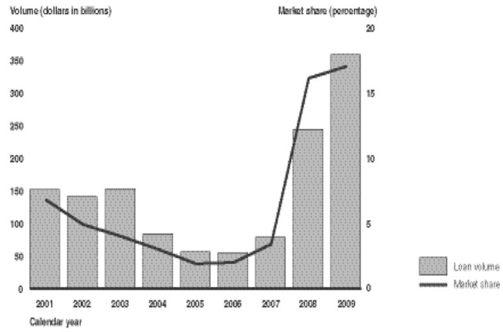
To enhance actuarial assessment of and reporting on the Fund, we are recommending that the Department of Housing and Urban Development (HUD) (1) require FHA's actuarial review contractor to use stochastic simulation of future economic conditions to estimate the Fund's capital ratio and (2) include the results of this analysis in FHA's annual report to Congress on the financial status of the Fund. Also, to strengthen accountability and transparency in FHA's management of the Fund, Congress should consider establishing a minimum time frame for restoring the capital ratio to 2 percent and clarifying a number of statutory provisions concerning FHA's administration of the Fund.

We provided HUD with a draft of the report on which this testimony is based for its review and comment. HUD provided technical comments, which are reflected both in the report and in this testimony.

## Background

FHA's single-family programs insure private lenders against losses from borrower defaults on mortgages that meet FHA criteria for properties with one to four housing units. In recent years, FHA has experienced a dramatic increase in its business volume and market role (see fig. 1). In 2009, FHA insured almost 2 million single-family mortgages, representing more than $300 billion in mortgage insurance and about 17 percent of the mortgage market. Historically, FHA has played a particularly large role among minority, lower-income, and first-time homebuyers. To help cover its insurance costs, FHA charges borrowers insurance premiums. As of September 1, 2010, FHA charged a 2.25 percent up-front premium and a 0.5 or 0.55 percent annual insurance premium, depending on the size of the borrower's down payment.

Figure 1: FHA Loan Volume and Market Share, 2001–2009




Source: GAO analysis of FHA data.

Legislation sets certain standards for FHA-insured loans. FHA borrowers who are purchasing a home must make a cash investment of at least 3.5 percent of the current purchase price. However, borrowers are permitted to finance their mortgage insurance premiums and some closing costs, which can create an effective loan-to-value (LTV) ratio—the amount of the mortgage loan over the value of the home—of close to 100 percent for some FHA-insured loans. Congress also has set limits on the size of the loans that FHA may insure, which can vary by county. In calendar year 2010, the limits range from $271,050 to $729,750 for one-unit properties in the continental United States.

The Omnibus Budget Reconciliation Act of 1990 required the Secretary of HUD to take steps to ensure that the Fund attained a capital ratio of at least 2 percent by November 2000 and maintained at least a 2 percent ratio at all times thereafter.[4] It also required an annual independent actuarial review of the economic net worth and soundness of the Fund. The annual actuarial review is now a requirement in the Housing and Economic Recovery Act of 2008 (HERA), which also requires that the Secretary of HUD submit an annual report to Congress on the results of the review.

Under the Federal Credit Reform Act of 1990 (FCRA), FHA and other federal agencies must estimate the net lifetime costs—known as credit subsidy costs—of

[4]Pub. L. No. 101-508

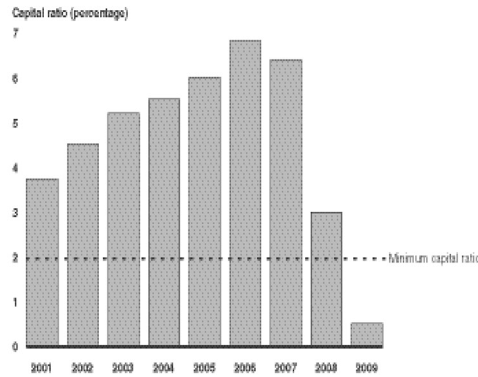
their loan insurance or guarantee programs and include the costs to the government in their annual budgets. Credit subsidy costs represent the net present value of expected lifetime cash flows, excluding administrative costs.[5] When estimated cash inflows exceed expected cash outflows, a program is said to have a negative credit subsidy rate and generates offsetting receipts that reduce the federal budget deficit. When the opposite is true, the program is said to have a positive credit subsidy rate—and therefore requires appropriations. Generally, agencies must produce annual updates of their subsidy estimates—known as reestimates—for each cohort on the basis of information on actual performance and estimated changes in future loan performance. FCRA recognized the difficulty of making credit subsidy estimates that mirrored actual loan performance and provides permanent and indefinite budget authority for reestimates that reflect increased program costs. Upward reestimates increase the federal budget deficit unless accompanied by reductions in other government spending or an increase in receipts.

## The Fund's Financial Condition Has Worsened in Recent Years Due to a Combination of Economic and Market Developments

After increasing earlier in the decade, the Fund's capital ratio dropped sharply in 2008 and fell below the statutory minimum in 2009, when a combination of economic and market developments created conditions that simultaneously reduced the Fund's economic value (the numerator of the ratio) and increased the insurance-in-force (the denominator of the ratio). According to annual actuarial reviews of the Fund, the capital ratio rose from about 4 percent in 2001 to about 7 percent in 2006, but fell to 3 percent by the end of 2008 and 0.5 percent by the end of 2009 (see fig. 2).

[5]For a mortgage insurance program, cash inflows consist primarily of fees and premiums charged to insured borrowers and proceeds from sales of foreclosed properties, and cash outflows consist mostly of payments to lenders to cover the cost of claims.

Figure 2: Estimates of the Fund's Capital Ratio, 2001–2009



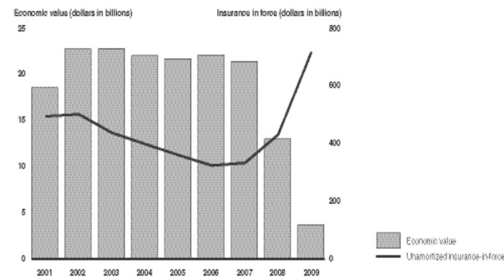

Source: GAO analysis of FHA data.

Major factors contributing to the decline in the economic value in 2008 and 2009 included:

- More pessimistic forecasts of economic conditions—house prices, in particular—which increased the number of predicted insurance claims and losses associated with those claims, thereby reducing the Fund's economic value. The economic value declined from about $21 billion at the beginning of 2008 to less than $4 billion by the end of 2009 (see fig. 3).

- The contraction of other segments of the mortgage market and legislated increases in the loan amounts eligible for FHA insurance, which resulted in higher demand for FHA-insured mortgages and increased FHA's insurance-in-force. From the beginning of 2008 to the end of 2009, the insurance-in-force rose from $332 billion to $715 billion (see fig. 3).

**Figure 3: Estimates of the Fund's Economic Value and Insurance-in-force, 2001–2009**

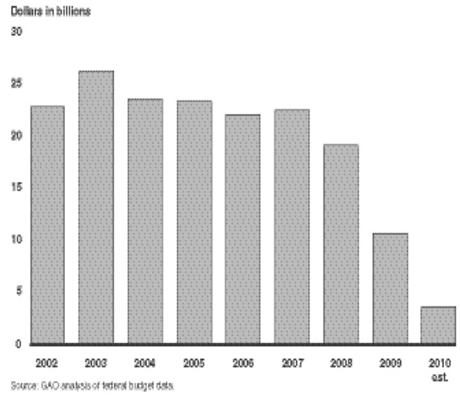



Source: GAO analysis of FHA data.

At the same time, the Fund's condition has worsened from a budgetary perspective. Historically, FHA has estimated that its loan insurance program is a negative subsidy program. On the basis of these estimates, FHA built up substantial balances in a budgetary account known as the capital reserve account. This account holds reserves in excess of those needed to pay for estimated credit subsidy costs and is used to help cover unanticipated increases in those costs—for example, increases due to higher-than-expected claims. Reserves needed to cover estimated credit subsidy costs are held in the Fund's financing account.[6] However, in recent years the capital reserve account has covered large upward reestimates of FHA's credit subsidy costs through transfers to the financing account. As a result, balances in the capital reserve account fell dramatically—from $22 billion at the end of 2007 to an estimated $3.5 billion by the end of 2010 (see fig. 4). If the reserve account were to be depleted, FHA would need to draw on permanent and indefinite budget authority to cover additional increases in estimated credit subsidy costs.

[6] The financing account records lifetime cash flows for loans insured in 1992 and thereafter. It appears in the budget for informational and analytical purposes but is not included in the budget totals or budget authority or outlays.

Figure 4: End-of-Year Balances in the Fund's Capital Reserve Account, 2002–2010




Source: GAO analysis of federal budget data.

## FHA Has Enhanced Its Approach for Assessing the Fund's Condition but the Current Methodology Does Not Fully Account for Future Economic Volatility

FHA and its actuarial review contractor have enhanced their methods for assessing the Fund's financial condition but still are addressing other methodological issues that could affect the reliability of estimates of the Fund's capital ratio.[7] Annual actuarial reviews of the Fund use statistical models to estimate the probability that loans will prepay or result in insurance claims on the basis of certain loan and borrower characteristics (such as LTV ratios and borrower credit scores) and key economic variables (such as house prices and interest rates). FHA and its contractor have enhanced these models in recent years, by incorporating additional variables that are related to loan performance and developed an additional model to predict loss rates on insurance claims. Also, consistent with recommendations we made in a prior report, the actuarial reviews began in 2003 to analyze the impact of more pessimistic economic

[7]For the 2009 actuarial review, FHA used a second contractor to conduct an actuarial analysis of Home Equity Conversion Mortgages (HECM) that were added to the loans included in the Fund starting with 2009 insurance commitments. Because HECMs currently have a small influence on the Fund's financial condition, we use "actuarial review contractor" to refer to the contractor that conducted the actuarial analysis of non-HECM loans.

scenarios—for example, nationwide declines in home prices—than they did previously.[8]

However, a significant limitation of the current methodology is its reliance on a single economic forecast to produce the estimate of the capital ratio that is used to determine whether the Fund is meeting the 2 percent capital reserve requirement. This approach does not fully account for the variability in future house prices and interest rates that the Fund may face. As a result, baseline estimates of the capital ratio may tend to underestimate insurance claims and mortgage prepayments and therefore may tend to overestimate the Fund's economic value. In a 2003 report, the Congressional Budget Office (CBO) concluded that FHA could project the Fund's cash flows more accurately by using a methodological approach—known as stochastic modeling—that involves running simulations of hundreds of different economic paths to produce a distribution of capital ratio estimates.[9]

FHA officials told us that they were planning to require the actuarial review contractor to use a stochastic simulation model for the 2011 actuarial review. These officials said that model would be used to examine the implications of extreme economic scenarios on the Fund but that decisions about using the model to estimate the Fund's capital ratio had not been made.

Given the uncertainty that always surrounds estimates of future economic activity, the report we issued yesterday recommends that HUD require the actuarial review contractor to use stochastic simulation of future economic conditions, including house prices and interest rates, to estimate the Fund's capital ratio and include the results of this analysis in FHA's annual report to Congress on the financial status of the Fund.

[8]GAO, *Mortgage Financing: FHA's Fund Has Grown, but Options for Drawing on the Fund Have Uncertain Outcomes*, GAO-01-460 (Washington, D.C.: Feb. 28, 2001).

[9]Congressional Budget Office, *Subsidy Estimates for FHA Mortgage Guarantees,* a CBO paper (Washington, D.C.: November 2003).

## FHA Has Taken Steps to Improve the Fund's Condition, but Certain Legislative Requirements for FHA's Administration of the Fund Provide Limited Direction

FHA has raised premiums and made or proposed policy and underwriting changes to help improve the financial condition of the Fund. For example, FHA raised its up-front premiums, is planning to increase down-payment requirements for riskier borrowers, and has proposed reducing allowable seller contributions at closing.[10] Additionally, to rebalance its premium structure while achieving a net increase in net premium revenue, FHA proposed raising the statutory ceiling on the annual premium and lowering the up-front premium. Consistent with this proposal, Congress enacted legislation in August 2010 raising the ceiling on the annual premium.[11] Budget estimates indicate that the rebalancing of the premium structure and the policy changes regarding down-payment requirements and seller concessions will increase the balance in the Fund's capital reserve account by $1.9 billion (according to a CBO estimate) or $5.8 billion (according to an FHA estimate) in 2011. Additionally, FHA has increased enforcement against noncompliant and poorly performing lenders and sought legislative approval to expand its lender enforcement authority.

However, some of the legislative requirements for FHA's management of and reporting on the Fund's condition provide limited directions to FHA. For example:

- The Omnibus Budget Reconciliation Act of 1990 did not specify a time frame for restoring the capital ratio to its required minimum level. FHA officials told us that while they have not set a deadline for restoring the ratio to the minimum level, they intend to do so as quickly as possible, consistent with FHA's statutory operational goals, such as providing mortgage insurance to traditionally underserved borrowers.

- A provision in HERA states that the Secretary may make programmatic or premium adjustments if the Fund will not maintain its "established target subsidy rate."[12] However, neither HUD nor Congress has established a target subsidy rate

[10]When FHA raised the up-front premium in April 2010, it was already charging the maximum annual premium allowed by law.

[11]Congress enacted Pub. L. No. 111-229 on August 11, 2010, which increased the ceiling on the annual insurance premium from 0.5 to 1.5 percent for borrowers with initial LTVs of 95 percent or less, and from 0.55 to 1.55 percent for borrowers with initial LTVs of 95 percent or more. The legislation also states that the Secretary of HUD may adjust any initial or annual premium by publishing a notice in the Federal Register or by issuing a mortgagee letter (a written instruction to FHA-approved lenders). On September 1, 2010, FHA issued Mortgagee Letter 2010-28 to increase the annual insurance premium to 0.85 percent for borrowers with initial LTVs of 95 percent or less and to 0.90 percent for borrowers with initial LTVs of more than 95 percent, and to lower the up-front insurance premium to 1.00 percent, effective for loans initiated on or after October 4, 2010.

[12]12 U.S.C. § 1708(a)(6).

for the Fund. FHA officials told us that the meaning of the term was not clear—indicating it could refer to a credit subsidy rate—but they have interpreted it to mean the capital ratio.[13]

- HERA also requires FHA to provide quarterly reports to Congress that include "updated projections of [the Fund's] annual subsidy rates." However, FHA has reported the credit subsidy rate only for the current loan cohort and, because credit subsidy rates generally are only updated annually, has reported the same rate for multiple quarters.[14] While FHA's quarterly reports do provide information on major factors affecting subsidy rates (such as claim, prepayment, and loss rates), the agency has other information that is does not routinely report that could provide insight into the future direction of the subsidy rates (such as cohort-level delinquency trends and economic forecasts).

In the absence of more explicit directions, the priority FHA should place on restoring the capital ratio versus its operational goals may be unclear, and Congress may not be receiving all of the information it would find useful to monitor the Fund's financial condition. Therefore, we believe that Congress should consider establishing a minimum time frame for restoring the capital ratio to 2 percent, taking into account FHA's statutory operational goals and role in supporting the mortgage market during periods of economic stress. Additionally, we believe that Congress should consider clarifying other statutory language, including (1) the definition of "established target subsidy rate" used in HERA and (2) the nature and extent of information that FHA should be reporting quarterly on subsidy rates.

[13]FHA, like other agencies, estimates credit subsidy rates for individual loan cohorts.

[14]Credit subsidy rates may be updated more than annually to reflect midyear policy changes. To reflect the April 2010 increase to its up-front insurance premium (1.75 percent to 2.25 percent), the credit subsidy rate in FHA's report for the third quarter of 2010 is more favorable than the rate in prior 2010 reports.

## The Performance and Characteristics of FHA-Insured Mortgages Have Changed in Recent Years, and Recent Cohorts Will Have a Major Influence on the Fund

Data on the performance and characteristics of FHA-insured mortgages illustrate the challenges and uncertainties facing the Fund as well as improvement in certain risk factors. As in other segments of the mortgage market, the performance of FHA-insured mortgages deteriorated as the economy weakened and home prices fell in 2008 and 2009. More specifically, FHA experienced increases in serious delinquency rates (percentage of active loans 90 or more days delinquent or in foreclosure) beginning in 2008 and continuing through 2009 after seeing a more stable pattern from 2005 through 2007. As of the last quarter of calendar year 2009, FHA's serious delinquency rate reached a historical high of 9.4 percent, a figure moderated by the fact that a large proportion of FHA's active loans are relatively new and have had limited time to potentially experience performance problems.[15] In recent years, changes in key loan and borrower characteristics of FHA-insured mortgages suggested some improvement in credit quality at loan origination. For example:

- As the contraction of the conventional mortgage market reduced mortgage options, even for borrowers with favorable credit histories, the proportion of FHA borrowers with stronger credit scores (680 and above) increased from 28 percent in 2008 to 44 percent in 2009.
- The percentage of loans with down-payment assistance funded by home sellers fell from about 19 percent in 2008 to 0 percent as a legislative ban on this assistance took effect in 2009. As we discussed in a prior report, loans with this type of assistance have significantly higher-than-average insurance claim rates.[16]

FHA has been closely monitoring the early performance of the 2009 loan cohort, which will have a major influence on the Fund's financial condition because of its large size (35 percent of the amortized insurance-in-force as of May 31, 2010). The 2009 cohort was projected to perform better than the 2006 cohort in the long run, but it is unclear from the early performance of the 2009 cohort whether this projection will hold.

In closing, because of the severe downturn in the nation's housing sector and FHA's expanded role in supporting the mortgage market, concerns exist about the rapid decline in the Fund's capital ratio to a level below the statutory

[15] As of the second quarter of 2010, FHA's serious delinquency rate had dropped to 8.45 percent.

[16] GAO, *Mortgage Financing: Additional Action Needed to Manage Risks of FHA-insured Loans with Down Payment Assistance*, GAO-06-24 (Washington, D.C.: Nov. 9, 2005).

minimum and FHA's estimation of this ratio. Prudent implementation of enhancements to FHA's modeling and estimation processes could improve the reliability of future capital ratio estimates and produce useful information about the Fund's ability to withstand economic stresses and meet statutory capital reserve requirements. Further, while Congress has enacted a number of provisions concerning FHA's management of and reporting on the Fund's financial condition, these provisions may not provide FHA with clear or specific directions. Enhancement and clarification of the provisions may help reinforce FHA's accountability for restoring and maintaining the capital ratio at the required level and improve transparency of the Fund's financial condition.

Mr. Chairman, Ranking Member Shelby, and Members of the Committee, this concludes my prepared statement. I would be happy to respond to any questions that you may have at this time.

## GAO Contact and Staff Acknowledgments

For further information about this testimony, please contact Mathew J. Scirè, Director, at 202-512-8678 or sciremj@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Individuals making key contributions to this testimony include Steven K. Westley (Assistant Director); Serena Agoro-Menyang; Dan Alspaugh; Joseph Applebaum; Marcia Carlsen; Tom McCool; Carol Henn; John McGrail; Marc Molino, Susan Offutt; José R. Peña; Bob Pollard; Barbara Roesmann; and Heneng Yu.

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**RESPONSES TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM DAVID H. STEVENS**

**Q.1.** What steps has the FHA taken to implement the PTFA?

**A.1.** In conjunction with the Office of Public and Indian Housing, FHA issued a Federal Register Notice (Docket No. FR-5335-N-01) on June 24, 2009, to provide general direction to participants in HUD programs regarding the requirements of the PTFA. A second Federal Register Notice (FR-5427) was published on October 28, 2010, which expands upon the Department's initial guidance and includes additional information regarding the updated PTFA provisions resulting from P.L. 111-203.

Additionally, FHA is presently drafting a Mortgagee Letter that will address the changes issuing from P.L. 111-203, as well as provide administrative guidance regarding the Occupied Conveyance Program and the impacts of the updated PTFA on its implementation. FHA expects to publish this Mortgagee Letter by February 1, 2011.

**Q.2.** Have these steps been fully implemented, including updating all notices to tenants and directions to FHA and contractor employees?

**A.2.** The pending Mortgagee Letter will provide amended notices to occupants. Mortgagees servicing FHA-insured mortgages are required to follow all Federal, State, and local legal requirements for both foreclosure and eviction actions. Mortgagees are expected to comply with the timeline provisions afforded by the PTFA for *bona fide* tenants before issuing a notice to vacate and proceeding with an eviction action.

**Q.3.** What steps does FHA plan to take to ensure that all renters in FHA-held properties are guaranteed their rights under the PTFA?

**A.3.** FHA is committed to ensuring that all tenants of FHA-held properties are afforded the full measure of their rights under the PTFA. Since the issuance of the PTFA, most tenant occupied properties that have been conveyed to HUD have been held by mortgagees until the period of time granted to tenants by the PTFA has elapsed. After providing any *bona fide* tenant the requisite time before issuing a notice to vacate, the mortgagee then conducted any required eviction and conveyed the property to FHA vacant. There have been several situations where a servicer contacted FHA and advised that a *bona fide* tenant had a lease of 12 months or more and requested permission to convey a property to FHA occupied. For the cases that were conveyed occupied, FHA has required that the contractor that manages the Department's real estate owned inventory not list the property for sale and expect the tenant to continue paying rent as required by the existing lease until it expires. FHA has not initiated eviction against any occupant of a HUD-held property since the issuance of the PTFA.

**Q.4.** *FHA Monthly Interest Charges.* Why is an FHA borrower charged interest through the end of the month regardless of when an FHA mortgage is actually paid off, either at the time a home is sold, or when an FHA loan is refinanced?

**A.4.** Interest on FHA insured mortgages is calculated on a monthly rather than *per diem* basis. Originally, this policy was designed to give FHA approved lenders adequate time to anticipate prepayments, develop close-out balances and arrange for reinvestment of prepayment funds. However, most of these time constraint concerns have been resolved by the lending industry's use of advanced technology. Nonetheless, there remain certain benefits to borrowers in calculating interest on a monthly rather than *per diem* basis. These benefits are explained in greater detail below.

**Q.5.** Does the FHA have regulatory authority to change this practice and, if so, would you consider making such a change? If you are not inclined to change this practice, why not?

**A.5.** FHA does have regulatory authority to change this. However, in the current market, the impact on lenders and servicers who are in the midst of managing tremendous challenges in the mortgage industry, the timing for such a change to FHA related business processes and systems would only compound those challenges and stretch resources even more thinly. Additionally, in a review of potential impact, which is based on FHA experience and discussions with lenders, FHA has considered the following:

- The monthly interest calculation provides FHA borrowers a grace period (generally 30 days) in which to make mortgage payments without incurring late payment fees and additional interest. This flexibility is a benefit to FHA borrowers who typically have fewer resources than conventional borrowers.
- The overall cost to the borrower of loans with interest calculated monthly is less than that for loans with interest calculated daily.
- Lenders are aware of the concern regarding the requirement for a full month's interest even after the loan is paid off and most address this concern by closing FHA insured mortgages at the end of the month, thereby minimizing the impact on borrowers at the time of loan payoff. Making a dollar value assumption of prepayment interest collections based on the number of FHA loan originations would not be accurate.
- A change to *per diem* interest to accommodate only those who pay off their mortgage at the beginning or in the middle of the month would effectively create an increase in the cost of borrowing for all FHA borrowers as lenders would most likely make up the loss by increasing interest rates.
- The change would require substantial changes to lender, servicer, and FHA systems and loan documentation.

The aforementioned analysis is not meant to imply that FHA is unwilling to change its practice of utilizing a monthly interest calculation in favor of a *per diem* calculation, but is offered to show that there are considerations other than alignment with the industry that apply specifically to FHA borrowers, lenders and servicers and must be taken into account with regard to this issue.

FHA acknowledges that, although the Federal Reserve has determined that the payment of interest beyond the payoff date on FHA insured mortgages does not constitute a prepayment penalty and therefore does not violate Regulation Z, it is still reviewing this issue and could change that determination in the future. However at this time, for the reasons stated above, FHA does not plan to pursue a change to the interest rate calculation.

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**RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM DAVID H. STEVENS**

**Q.1.** *Early Term Delinquencies.* What threat do early term delinquencies, those mortgages which default in the first 18 to 24 months after origination, pose to FHA?

**A.1.** Generally, early term delinquencies demonstrate that borrowers did not meet loan eligibility requirements at the time the loan was approved. Borrowers with early payment delinquencies are often unable or unwilling to meet their debt obligations, which results in a higher risk of foreclosure. If a lender forecloses on an FHA-insured loan, FHA is obligated to pay the claim. If the claims on aggregate exceed projections, it may impact the FHA Mutual Mortgage Insurance Fund.

**Q.2.** What do you think about a proposal which would require the FHA to establish a program which would review all early term delinquencies and require that the FHA indemnify any mortgages that were originated fraudulently and further examine the loans of the company that made those loans?

**A.2.** As of October 4, 2010, FHA began to review all loans 90 days delinquent within the first 6 payments. In addition, FHA actively monitors lenders for excessive early term delinquencies, fraud and other risks to the FHA Mutual Mortgage Insurance Fund. FHA uses these performance measures to determine which lenders FHA will select for compliance reviews. As a result of deficiencies cited during these compliance reviews, FHA may seek indemnification against losses on loans with fraud or material misrepresentation.

**Q.3.** Why shouldn't Congress require that all mortgages found to be originated fraudulently or not to FHA requirements be put back on the company that originated the loan?

**A.3.** FHA takes very seriously any misconduct or deception on the part of participants in its programs. Such violations undermine public trust and negatively affect the housing industry and consumers. FHA is committed to its mission to stabilize the housing market, maintain and expand home ownership, and operate with a high degree of public and fiscal responsibility. Accordingly, all FHA-approved lenders must comply with applicable laws and regulations. Lenders that violate HUD program statues, regulations, and requirements are subject to appropriate sanctions, including, invalidating the contract of insurance for those loans originated or underwritten with fraud or material misrepresentation. The expanded indemnification authority currently being sought by FHA would greatly assist the Department in ensuring that lenders who violate FHA requirements bear the consequences of their recklessness, and that FHA's insurance funds are better protected against unnecessary losses.

**RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM MATHEW J. SCIRÈ**

**Q.1.** Mr. Scirè, in your testimony you recommend that, "Congress should consider establishing a minimum time frame for restoring the capital ratio to 2 percent and clarifying a number of statutory provisions concerning the FHA's administration of the Fund." Do you think that should be a hard deadline? How much time should Congress give the FHA to rebuild the capital ratio once it dips below 2 percent?

**A.1.** Congress would need to weigh FHA's financial soundness with its public purpose in establishing a time frame for FHA to restore the capital ratio to 2 percent. A shorter time frame with a rigid deadline would place greater weight on the financial health of FHA's insurance fund. A longer time frame with a more flexible deadline would place greater weight on FHA's role in supporting the mortgage market during periods of economic distress. To inform its decision making on this issue, Congress may find it instructive to consider what occurred in 1990, when the 2 percent requirement was enacted. Then, as now, the capital ratio was below 1 percent and FHA accounted for a significant share of the mortgage market. At that time, Congress gave FHA 10 years to achieve a 2 percent capital ratio, and the agency reached it in 5 years.

**Q.2.** Please detail which other statutory provisions require clarification and how should they be clarified?

**A.2.** We identified three statutory provisions regarding FHA's management and reporting of the Fund's condition that Congress should consider clarifying.

- First, a provision in the Omnibus Budget Reconciliation Act of 1990 defined the capital ratio as the economic value of the Fund divided by the "unamortized insurance-in-force," which is generally understood as the initial insured loan balance. (12 U.S.C. §1711(f)(4)(B)). However, another provision in the Act defines unamortized insurance-in-force as the remaining loan balance, which is generally understood to describe the amortized insurance-in-force. (12 U.S.C. §1711(f)(4)(D)). To avoid confusion about the meaning of these provisions, we believe that Congress should consider making them consistent. We believe that the amortized insurance-in-force is the appropriate measure of the Fund's potential liability and should be used for purposes of defining the capital ratio.
- Second, a provision in the Housing and Economic Recovery Act of 2008 (HERA) states that if the Secretary of HUD determines there is a substantial probability that the Fund will not maintain its "established target subsidy rate," the Secretary may make programmatic or premium adjustments. (12 U.S.C §1708(a)(6)). However, neither HUD nor Congress has established a target subsidy rate for the Fund. FHA has interpreted the term to mean the capital ratio, but it could also be interpreted as a credit subsidy rate (a budgetary measure of the estimated lifetime cost of each annual loan cohort). While FHA's interpretation is consistent with the legislative language that

HERA amended, we believe that Congress should replace "target subsidy rate" with a less ambiguous term.

- Third, HERA requires FHA to provide quarterly reports to Congress that include "updated projections of [the Fund's] annual subsidy rates to ensure that increases in risk to the Fund are identified and mitigated . . . and the financial soundness of the Fund is maintained." (12 U.S.C. §1708(a)(5)(E)). Because credit subsidy rates generally are only updated annually, FHA has reported the same subsidy rate information in multiple reports. If the purpose of the reporting requirement was to provide Congress with current information on factors that may affect subsidy rates, we believe that Congress should specify more clearly the nature and extent of the information that it is seeking. In our report, we cited cohort-level delinquency trends and changes in economic forecasts as examples of the types of information that Congress may find useful.

**Q.3.** The FHA has asked Congress for the ability to indemnify mortgages that are found to be fraudulent. Should the FHA be required to indemnify those mortgages or should it be left to the discretion of the Commissioner whether or not to indemnify fraudulent mortgages?

**A.3.** We have not conducted work on FHA's indemnification authority and therefore have not explored whether or not there are circumstances under which the Commissioner would require discretion to effectively exercise this authority.

**Q.4.** What threat do early term delinquencies, those mortgages which default in the first eighteen to twenty four months after origination, pose to FHA? What do you think about a proposal which would require the FHA to establish a program which would review all early term delinquencies and require that the FHA indemnify any mortgages that were originated fraudulently and further examine the loans of the company that made those loans?

**A.4.** Early default rates are an important gauge of the strength or weakness of recent loan cohorts. They are also an indicator of potentially unsound underwriting practices (including fraud) that can lead to foreclosures and FHA insurance claims. Therefore, we believe that early defaults and lenders with relatively high proportions of such loans should be subject to close review and oversight. Important factors to consider in evaluating a proposal to review all early defaults are the capacity of FHA's workforce to conduct such reviews and how the reviews would fit in with FHA's existing oversight and enforcement efforts, which include onsite examination of lender loan records and sanctions against lenders with high early default and claim rates. At the request of the Chairman and Ranking Member of the Senate Committee on Banking, Housing, and Urban Affairs, we are currently reviewing FHA's capacity to oversee lenders and other program participants.

**Q.5.** Should the FHA continue to allow borrowers to finance mortgage insurance premiums and closing costs? As you state in your testimony in some cases this results in a mortgage loan over the value of the home. What risk does that expose the taxpayers to given that they ultimately stand behind 100 percent of the value of the loan insured—a very real exposure given the FHA is currently below its mandatory 2 percent capital ratio requirement?

**A.5.** Although FHA requires borrowers to make a cash investment of at least 3.5 percent of the home's purchase price, FHA's policy of allowing borrowers to finance their upfront insurance premium and some closing costs results in an effective loan-to-value (LTV) ratio of close to 100 percent for some FHA-insured mortgages. We and others have reported on the importance of the LTV ratio as a predictor of default. [1] The higher the LTV ratio, the less cash borrowers will have invested in their homes and the more likely it is that they may default on mortgage obligations, especially during times of economic hardship. Not allowing FHA borrowers to finance upfront premiums and closing costs would reduce FHA's financial risk (all other things being equal) but also would make it more difficult for some borrowers to qualify for mortgages. Any changes to FHA's current policy would need to consider this tradeoff.

**Q.6.** Should the FHA continue to insure 100 percent of the value of the loan? How does this compare to the structure of private mortgage insurance? Does the FHA's structure create an incentive for mortgage originators to prefer FHA insurance to private mortgage insurance?

**A.6.** In a 2007 report, we discussed a number of options for increasing FHA's operational flexibility, including authorizing FHA to insure less than 100 percent of the loan value. [2] At that time, private mortgage insurers offered several levels of insurance coverage up to a maximum of 40 or 42 percent (depending on the company) of the value of the loan. Since most FHA insurance claims are offset by some degree of loss recovery, some mortgage industry observers have suggested that covering 100 percent of the value of the loan may not be necessary. While lower coverage could cause a reduction in the volume of FHA-insured loans and a corresponding decline in income from premiums, it could also result in reduced losses and ultimately have a beneficial effect on FHA's insurance fund. However, partial FHA coverage may lessen FHA's ability to stabilize local housing markets when regional economies decline and may increase the cost of FHA-insured loans as lenders set higher prices to cover their risk. We have not examined the extent to which FHA's insurance structure affects incentives for mortgage originators.

**Q.7.** Have you examined whether or not the solvency of the FHA's fund would benefit from increasing the minimum down payment requirement from 3.5 percent to 5 percent? If so, what did you learn?

**A.7.** We have not examined this particular question. However, our prior work indicates that lower LTV ratios (*i.e.,* higher down pay-

[1] GAO, Mortgage Financing: Actions Needed To Help FHA Manage Risks From New Mortgage Loan Products, GAO-05-194 (Washington, DC: Feb. 11, 2005).

[2] GAO, Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management, GAO-07-708 (Washington, DC: June 29, 2007).

ments) and the absence of down payment assistance reduces FHA's financial risk, all other things being equal.[3]

[3] *See,* GAO-05-194 and GAO, Mortgage Financing: Additional Action Needed To Manage Risks of FHA-Insured Loans With Down Payment Assistance, GAO-06-24 (Washington, DC: Nov. 9, 2005).