PERSPECTIVES ON THE HEALTH OF THE FHA SINGLE-FAMILY INSURANCE FUND

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PERSPECTIVES ON THE HEALTH OF THE FHA SINGLE-FAMILY INSURANCE FUND

Thursday, December 1, 2011

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Spencer Bachus [chairman of the committee] presiding.

Members present: Representatives Bachus, Hensarling, Royce, Manzullo, Biggert, Miller of California, Capito, Garrett, Neugebauer, McHenry, Campbell, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hayworth, Renacci, Dold, Schweikert, Canseco, Stivers; Waters, Maloney, Gutierrez, Velazquez, Ackerman, Sherman, Capuano, McCarthy of New York, Baca, Lynch, Miller of North Carolina, Scott, Green, Cleaver, Ellison, Donnelly, Carson, and Carney.

Chairman BACHUS. The committee will come to order.

Today, the committee meets to review the recently released Fiscal Year 2011 actuarial study of the FHA Mutual Mortgage Insurance Fund. I welcome Secretary Donovan, Acting FHA Commissioner Galante, and our other witnesses today.

And I would like to take this opportunity to express to you, Secretary Donovan, on behalf of the people of Alabama, their regards and appreciation for your efforts during the tornadoes that struck Alabama. The response was excellent, and we appreciate your professionalism.

Two years ago, this committee met to hear disturbing news that the FHA capital reserve ratio, which is the primary barometer for measuring the FHA financial solvency, had deteriorated to a level of .53 percent, which is well below the statutory requirement of 2 percent. Since then, things have gotten worse. The capital reserve experienced a further decline to .5 percent in 2010, and then on November 15th of this year, the independent actuarial study revealed the capital reserve ratio had fallen more than half and now stands at .24 percent.

Having said that, we should also acknowledge that we have witnessed a historic housing market correction with the largest drop in home prices in history and the worst economic downturn since the Great Depression. With this background, it is not surprising that the FHA capital reserves have suffered. We also need to recognize that a substantial part of the problem results from legacy loans originated during the housing bubble prior to the economic downturn. Current loans have much higher credit scores and a markedly better performance.

I am encouraged that the FHA has implemented some incremental reforms to shore up the insurance fund reserves and reduce risk, including the hiring of a Chief Risk Officer. However, I think our witnesses have acknowledged, these reforms are not enough.

I share the concerns expressed in a November 7th GAO report that FHA has yet to implement a comprehensive risk assessment strategy. A separate GAO study released last week on Ginnie Mae, which guarantees the payment of principal and interest to investors and securities backed by FHA-insured mortgages, found that Ginnie Mae faces a risk of financial loss due to inadequate or failed internal processes because of limited staff, substantial reliance on outside contractors instead of Ginnie Mae employees, and the need for modernized information services.

Both of these GAO reports, coupled with an independent actuarial study, all released within the last month, do not paint a picture of a government agency prepared for the 21st Century, let alone the immediate housing financial crisis.

Finally, Mr. Secretary, let me reiterate that I share your and the Administration's opposition to any increase in FHA loan limits. The new levels of $729,500 at 100 percent government guarantee passed recently by Congress was not the right course of action for creating an environment where the private sector can compete on a level playing field with government-subsidized entities in our housing markets.

I look forward to your testimony, as well as that of the other witnesses.

At this time, I recognize Mr. Gutierrez for 4 minutes.

Mr. GUTIERREZ. Thank you, Chairman Bachus, for holding this hearing, and I welcome Secretary Donovan and our other witnesses. I look forward to our discussion today on the Federal Housing Administration, the health of its single-family insurance fund, and the role that it continues to play in the housing market.

We are going to get into the details today talking about actuarial studies and capital reserves. These are important issues that we must understand. What we know is that the FHA's capital reserve ratios have fallen and continue to be below the level required by statute. That is a fact we have to deal with. But the real questions that we have to ask today are why is this the case, and what can we do to ensure that the fund stays in the black going forward?

I think we can dismiss some theories pretty quickly; for example, the idea that the FHA has acted irresponsibly under this Administration, or that it is actively trying to grow its way out of the problem. Those ideas are simply absurd, despite the talking points of some of my colleagues.

Most of the loans that are hurting the FHA were made during the Bush Administration. The FHA, with the help of Democrats in Congress, has tightened its underwriting standards, raised annual insurance premiums, and increased downpayment requirements for borrowers with lower credit scores. If anything, these are all policies that have reduced the FHA's potential footprint in the market. Those are just facts.

The fundamental problem is that we are still in the grips of a foreclosure crisis that is hurting American homeowners, the FHA's balance sheet and, indeed, our entire economy. I think that we have to focus on this fundamental issue in order to have a useful conversation about maintaining the health of FHA into the future.

We also have to talk about where this Congress is putting resources. Are we spending the money to ensure that Americans have access to housing counseling to avoid foreclosure? I think not. Are we adequately requiring lenders to provide loan modifications for borrowers who are delinquent on their mortgages? I think we need to ask that question even more. Are we doing more to ensure that principal reduction is on the table of modification process?

All of these things would improve the health of our housing market, improve the health of the FHA, and, most importantly, improve our economy, but I can't say that I think we have done enough to help American homeowners who are threatened by foreclosure or are underwater on their mortgages.

The more loans we modify, the healthier the FHA funds will be. I hope that we spend time today talking about what the FHA and other agencies can do to hold servicers—and I want to ask the Secretary specifically about this—accountable, encourage more successful loan modification to keep families in their homes, and get our housing stock back on a steady growth. I look forward to the testimony today discussing how we can fix the problem. I thank you, Chairman Bachus, and I yield back the balance of my time.

Chairman BACHUS. Thank you, Mr. Gutierrez.

And at this time, I recognize the vice chairman of the full committee, Mr. Hensarling, for 2 minutes.

Mr. HENSARLING. Thank you, Mr. Chairman.

FHA is likely a disaster in the making. If we are not careful, it may become Fannie Mae and Freddie Mac, the sequel.

At 400-to-1 leverage, 10 times the leverage that was employed by Lehman Brothers when they filed their bankruptcy, something is amiss. The capital reserve ratio is almost 90 percent less than the statutorily required minimum—working in the third year in a row where the Mutual Mortgage Insurance Fund has been undercapitalized. If FHA was a private financial institution, likely somebody would be fired or fined, and the institution would find itself in receivership. Instead, what we have seen is an agency that has undertaken an expansionary strategy whose aggregate insurance in force has more than tripled since 2008. We have an agency that now guarantees mortgages up to roughly twice what they did just a few years ago, certainly an example of extraordinary mission creep.

It is estimated that more than half of FHA's current insurance in force is on mortgages taken out by owners who have negative equity in their homes. FHA's seriously delinquent rate for September was 8.7 percent, up from 8.2 percent in June, at a time when many believe that we will see further erosion in home values.

In February 2011, in the Administration's report to Congress, they said, "FHA should return to its pre-crisis role as a targeted provider of mortgage credit access for low- and moderate-income Americans and first-time homebuyers." Before the taxpayers get soaked yet again, I hope that the Administration's actions will match their rhetoric.

I yield back the balance of my time.

Chairman BACHUS. Thank you.

Mr. Scott is recognized for 3½ minutes.

Mr. SCOTT. Thank you very much, and, Secretary Donovan, it is good to see you.

First of all, I want to start off by thanking you and HUD for the very valuable assistance you gave me in dealing with our home foreclosure situation in Georgia. Georgia is the epicenter of home foreclosure, and my district, which represents the suburban areas of the Atlanta metropolitan area where so many of the huge home subdivisions are particularly hit, that comes almost 2 years after we had the great flood. So our housing situation in that area is very serious, and in that regard, we put together a home foreclosure event with the assistance of HUD.

And I really want to say thank you to a couple of people on your staff: Audrey Crutchfield—I think you may know her—and also Ed Jennings, who is a regional person. And when you thank them, I want you to encourage them to do it again with me, because this problem is still there.

We were able to help save over 2,500 homes, but that is just a drop in the bucket. We need to get help down there very seriously, and if we start early enough, if we want to start this year, we could save 10,000 homes. We are particularly serious with the areas of that combined impact of high unemployment, people without jobs. We have a severe problem with a lot of elderly. There is no reason for us to have to put 90- and 100-year-old elderly people out. Where are they going to go? How are they going to get help? We were able to save one of those fellow Georgians just this week, as you know. And we have kept them in their homes thanks to the good graces of one of our sheriffs there.

This FHA was put together as a result of the Depression, in 1934, and it was put together for these very pressing reasons. We need to do that despite the efforts last April, where I think the Congress cut $88 million. That is devastating to your Department.

So there is a role that we are playing in these cavalier budget cuts that goes straight to the heart of where the greatest need is for the problem; if there ever was a need for us to look very gingerly and avoid these massive budget cuts that helped to exacerbate the very problems that I am talking about. And so, we want to get into that today, and I hope we can get a message across loud and clear that we need to reverse this rather disturbing trend to try to balance the budget on the backs of those areas of our service to the American people where they need the help the most and call upon those who can afford it, those multibillionaires and millionaires who are not paying their fair share, to help.

This is a primary example of where we are. America is a great country, and just as we rose out of the ashes of the Depression and formed the FHA at that time, surely this is a time in which we can serve its great sterling purpose and strengthen the funding for HUD.

So I appreciate your being here. Thanks again for your work, and let your folks know we look forward to working with them again next year. We are putting that home foreclosure event together as we speak, and hopefully we can contact your office. Thank you.

Secretary DONOVAN. Thank you.

Chairman BACHUS. Mr. Royce, did you want a minute, or a minute-and-a-half?

Mr. ROYCE. Thank you very much.

Chairman BACHUS. One-and-a-half minutes then.

Mr. ROYCE. Very good. Thank you, Mr. Chairman.

In 2008 and 2009, some of us were warning about the potential risk of this government agency heading toward their statutorily mandated 2 percent capital reserve ratio, and we had hearings like this one, and we were told at the time not to worry. The testimony was that the FHA was fine, and the reforms being made were going to prevent a taxpayer bailout. I remember we had, in October of 2009—then-FHA Director Stevens was here. He came before the committee, and his words were these: "We will not need a bailout."

Secretary Donovan, in reviewing your prepared remarks, it is clear that you are laying out a very different scenario here. And given the actuarial report from 2011, I can see why. In that report, the capital reserve ratio is now one-quarter of 1 percent, which is a fraction of the statutorily mandated 2 percent. And this leverage ratio is really—it is about 244 to 1. That would give pause, I think, to any regulator at this point.

And so the obvious question that I think we hope to get answered as you lay out your plan is, what is next, Mr. Secretary? What is your solution for preventing a taxpayer bailout of FHA?

I think it is clear that banking on a quick turnaround in the housing market, I think that rebound is not the safe way to bet. I think you need to lay out a scenario where we have a plan that moves us back from the brink that could lead to a bailout. I very much appreciate your being here, and I am looking forward to hearing your testimony here today. And I yield back the balance of my time.

Chairman BACHUS. Thank you.

Mr. Green for 2 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank you and the ranking member for having the hearing.

Thank you, Mr. Secretary, for appearing today, and I am hopeful that what you will present to us will help us to understand how the housing market can bounce back with the help of FHA.

Your credit scores have gone up to 700, average credit score. You have been assisting in areas where the market, in general, does not receive a lot of help from other institutions. I think that we have to concern ourselves with the housing market in terms of the recovery, and I see FHA as a part of that recovery effort. So I thank you for appearing and trust that when you have completed your testimony, we will have greater insight into how FHA will play a meaningful role.

And I yield back the balance of my time.

Chairman BACHUS. Thank you.

Mr. Miller for 1½ minutes.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

Secretary Donovan, thank you for meeting with me this morning. We had a nice conversation beforehand, and we do need to look for ways to shore up the FHA insurance fund. Falling home prices are really the major reason you are in the situation you are in today, and until we reform the housing system, home values will continue to falter, people will lose money, and this economy will not turn around.

But the housing market is a very, very complex marketplace. There is no doubt we need to look to try to bring the private sector back to fill the void that has been created out there, but until we do that, somebody has to step forward to make sure there is liquidity in the marketplace.

That was the reason we formed the FHA and the GSEs, to do that, but many times what we do is very local. I told you about the situation we are facing in a part of my district, Chino Hills, about the people who are suffering from the Edison towers that were put in the right-of-way behind their homes. That was nothing to do with them, nothing to do with Edison. The State of California mandated "X" amount of renewable energy must be provided in the State of California, so they installed these 200-foot towers behind homes.

The problem is that FHA does not lend in certain areas. Now, there are many FHA loans within that area right now because the homes are out of the right-of-way, but the towers have doubled in size, and now they are within a fall zone. And I know it is a gray area for you, but it is a very serious area for the people who have been impacted.

I want to thank your staff for working with us on this issue, but it is something that we need to look at and ask, what is right? The people bought in good faith. They are not in a right-of-way, but what the State of California has mandated has put them in a very difficult situation, and it has impacted them in the pocketbook. Not only has the marketplace had a negative impact on them as falling prices have, but now what has been done to them for the betterment of the State, so-called, has had a really dire impact on their finances, and they are angry. They have a right to be.

When we have an opportunity to do good, we need to look at that. And I would just encourage you to look at what you can do in that area. Whatever help you can provide these people, they would really appreciate it. It is through no fault of their own. They bought in good faith, they have lived there for years in good faith, and now they are being impacted by this. But I want to thank you, and it is a huge issue, and whatever you can do, I would appreciate it.

I yield back.

Chairman BACHUS. Mr. Lynch for 1 minute.

Mr. LYNCH. Thank you, Mr. Chairman.

I want to thank the witnesses for appearing before this committee, and helping us with our work. I want to hearken to the remarks of Mr. Royce of California. I was in on these meetings as well when we raised concerns about the capital ratio back in 2008, and we received direct assurances from FHA "not to worry, we have our arms around this, we are going to handle this, we are not going to go below the statutory minimum." Then, they did. We called you back. I had meetings in my office. We had reassurances again that you were going to handle this. And here we are.

Now, you have dug yourself in such a deep hole that you are going to need some funding, you are going to need a bailout, or you are going to need some drastic measures to dig yourself out of that hole, and that is a problem. There seems to be a pattern of denial that things were going to get better, and we are going to turn this thing around, and we didn't hear a peep to reverse this decline. And that is a problem because now the problem is significant, and it is going to be more difficult dealing with it now because we have allowed this shortage to accumulate.

So I am just disappointed that we didn't have the acknowledgment that we had raised up here that we saw happening that wasn't reflected at the agency. And there were things that we could have done that would have been less destructive several years ago than the hand that we have to play now, and there are a lot of people in this country, a lot of homeowners, who are relying on—

Chairman BACHUS. Mr. Lynch is recognized for an additional 15 seconds.

Mr. LYNCH. Thank you.

We have to work together here. We can't have us raising concerns and the agency blowing us off and saying there is no problem, and then it is a mess, and then we have to do something drastic to correct it. We need to work better together, I guess. And I will be interested in hearing how you are going to come up with this money, all these resources, to fill in the shortfall.

Thank you. I yield back.

Chairman BACHUS. Thank you.

Mrs. Capito for 1½ minutes.

Mrs. CAPITO. Thank you.

I would like to welcome Secretary Donovan back to the committee as well, and I want to thank the chairman and the ranking member for the hearing today. Having sat through many of these hearings over the last several years, I think, as the speaker before me says, when a red flag is in front of us, we need to pay attention. I think we see a major red flag here with the decline in the capital ratio.

In the Secretary's defense, I would say he has begun, or attempted anyway, improvements to the program like raising the annual premiums and other things that could be done, but we need to work hand in hand both legislatively and through regulation to try to improve what is a seriously declining and, I think, potentially dangerous situation.

With the actuarial report saying that the mandated reserve ratio is down to .24 percent, it is time to more than just pay attention; it is time to take action. And so, I pledge to work with you as we have in the past. We did an FHA reform bill last year. I believe it didn't make it all the way through, and I think some of the ideas in that bill would be very useful in helping to alleviate this situation.

Changes that are currently in practice, like tightening the underwriting standards, increasing premiums, and enhancing enforcement, I think are helping, but the statistics are showing that we are still in a seriously declining situation, and as we have heard repeatedly, and I would echo my voice in this, a bailout to the FHA is something that would be intolerable to the American people and certainly to this Congress.

So I would like to thank the chairman for holding the hearing and welcome the Secretary today. Thank you.

Chairman BACHUS. Thank you.

Mrs. Maloney for 2 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, and Mr. Ranking Member, and I am really honored to welcome all of the panelists today, particularly Secretary Donovan, and to say that New York is so proud of you. Thank you so much for your public service to our State and City, and thank you also for your public service for our Nation.

This is a very important hearing because the FHA really represents a critical leg of the stool of housing finance. And I think it is safe to say that in the wake of the most recent financial crisis, we are all concerned about the FHA's ability to continue to insure mortgages.

Over the last year, the FHA has insured $218 billion in single-family mortgages, helped more than 362,000 families avoid foreclosure through loss mitigation, and helped 440,000 families refinance their mortgages to a lower rate. Some of these families who have benefited live in the district I am honored to represent, and they are very grateful.

So the importance of FHA's role in the housing system really must be underscored. And FHA is really the only game in town right now because the private sector has largely disappeared from the market.

However, I am concerned, and I join my colleagues who have expressed their concerns, that the actuarial report indicated that the FHA's Mutual Mortgage Insurance Fund capital ratio fell from .50 percent in 2010 to 24 percent in 2011. And I do know that there are a variety of reasons that led to that decline, including a decline in home prices, but I hope that we will see an uptick in that rate as the market stabilizes. And I believe the actuarial report, with a lot of hard work and help from the economy, that we can move toward the level of 2 percent by 2014.

In the meantime, I understand that FHA has undertaken a number of important steps to ensure the health of the fund by strengthening risk controls, underwriting controls, and enforcement; increasing premiums; and expanding loss-mitigation assistance to avoid unnecessary claims.

So I look forward to your testimony. I particularly would like to hear your take on the legislation on FHA reform that has been presented by the Republican Majority, and again, I thank you for your efforts to help Americans stay in their homes and finance their homes. Thank you very much.

I yield back.

Chairman BACHUS. Thank you.

Mr. Garrett for 1 minute.

Mr. GARRETT. I thank the chairman for holding this very important hearing on FHA and its future viability, in light of the new actuarial report that just came out which raises real concerns. Unfortunately, as you know, Congress just decided to expand the role of the FHA even before they had the opportunity to study that report in depth.

Mr. Secretary, you have been in your position for about 3 years. Each year the actuarial report comes out, and each year it shows deterioration, gets worse and worse and worse with regard to the capital position. And as Mr. Lynch has already indicated, prior to that, each year you come here and basically you or your subordinates say things are fine, that we are in good financial condition, and that your projections show that things will get better year after year.

However, as I say, if you look at those reports that come after you speak to us, things continue to deteriorate, they get worse and not improve. They erode. So when you come here now and tell us, don't worry, be happy, things are okay and improving, I have heard that record before, and I really wonder why we should believe that and why we should not anticipate that in a few months from now, this spring, you will be coming to Mr. Lynch and me and the rest of us saying you need to be bailed out.

I add to that just one other comment. I have heard some comments at least out there from Mrs. Galante that even with this alarming situation, the FHA is not really going to make any other additional significant policy changes to better its fiscal position; rather, the answer is simply to grow its way out of it. And I really wonder, then, whether or not growing your way out of this problem is not only doing more damage to yourself, but also doing more damage to the private sector in freezing out private mortgage guarantors and the rest of the private sector by doing so.

So I have a lot of concerns as to this track record to date, and also where we are going with this.

I yield back.

Chairman BACHUS. Thank you, Mr. Garrett.

Mr. Ackerman for 2 minutes.

Mr. ACKERMAN. Thank you, Mr. Chairman, and I thank the ranking member for the hearing.

Mr. Secretary, indeed we are all proud of you. Thank you for the great job you are doing under very difficult circumstances.

I don't think the sky is falling. Unlike some of my colleagues, I think you are to be congratulated, not criticized, for the fact that your market share is expanding, or, as some people have said, exploding. Your agency has been designed for that purpose, to be countercyclical, to pick up the slack when there are no other lenders. That is your job, and that is your role, and you are doing it, and you are doing it quite well despite the fact—or I point out the highlight of the fact is that the quality of your borrowers has increased, as the audit indeed shows for the first time, being over 700 on the FICO scores. That is a very good sign and a very positive sign in very troubling times.

There are some reasons to be concerned, and I think your testimony that we have seen so far is very, very realistic, and we have to figure out what to do if indeed the housing market continues to decline and prices decline anyway.

My second point is basically during the years of the Bush Administration, they kind of branded themselves as the ownership society. Everybody had to own something, especially their house, and people found ways to market houses to people who were basically subprime borrowers. There were really no subprime loans, they were pretty tricky and some devious, but the borrowers were subprime.

Now that we have highlighted that, I thought we had gotten away from some of the causation of the problem, but I find that an ad—and I have seen many like it—this is from one of the major newspapers in my region in New York—Cambria Heights: "Foreclosure. One-family brick plus private driveway, full basement. Asking $163,000. No credit, bad credit okay. Won't last. Call quick."

Why are we still selling and marketing to people who have no credit and bad credit? This is not advertised as being out of your shop in any way, I don't want to advertise it, but this is still going on. People are being induced by lenders—not your agency, but by lenders to buy houses when clearly they are marketing it to people who can't afford it. No credit, bad credit. Who are they asking to buy houses? What do we do about that?

And I will yield back the balance of my time because I do have some specific questions for you when that moment comes.

Chairman BACHUS. Thank you, Mr. Ackerman.

And let me at this time acknowledge that Ms. Carol Galante, who is the Acting Federal Housing Administration Commissioner, is seated at the witness table with Secretary Donovan and is accompanying him today. We appreciate your presence and understand you are going to assist, if needed, the Secretary. And I have enjoyed our conversations over the past few months. So we welcome you to the hearing.

Thank you.

Mr. Neugebauer for 2 minutes.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Chairman BACHUS. We are having a little longer opening statements, but these are important matters, and I think it is important that those Members who wish to make an opening statement can do so.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Secretary, it is good to have you here. The Mortgage Insurance Premium Fund report was issued, and it was a little ironic because it didn't paint a very pretty picture, but the summary said that it was actuarially sound. And I was pretty sure if I went to Webster's, that an entity that had less than one penny of equity—and, in fact, it is not less than one penny, it is less than a quarter of a penny in equity—with such a huge book of business would not be an entity that was probably actuarially sound.

And I think the other thing that was troubling about that, and I think my good friend Mr. Garrett made the point, is when we go back, if you look at previous reports, and you look at the projections of where you thought you were going to be in the outyears, we have missed those every year.

And the other piece of information there is that when you look deeper into the numbers here, and I am looking, that when you look at the single-family book of business, actually that reserve is even less than that. It is .12 percent. I was trying to decide how much of a penny that you could show to represent that. That is like

846-to-1 leverage, and obviously that is leverage that any other entity in this country that was regulated would be in some kind of either bankruptcy or conservatorship. So, one of the things, the challenges, here is how do we fix this? And I think that is an important piece of that.

One of the problems, though, I think, even beyond being out of money at this particular point in time, is the fact that because we have crowded the private market out of the system here, you are getting a majority piece of the business, and so it is almost a self-fulfilling prophecy that if we were to take actions to reduce the amount of business that FHA is doing, reduce your market share back to traditional levels, you wouldn't have the new income levels to support the activities that you are in right now.

So it is going to be interesting to hear from you how we bring FHA back to more traditional levels as far as market share and at the same time keep you from having to dip into the taxpayers' fund.

And so, I look forward to the question-and-answer period where you and I can discuss that further. And thank you, Mr. Secretary.

Chairman BACHUS. Thank you.

Ms. Hayworth for 1 minute.

Dr. HAYWORTH. Thank you, Mr. Chairman.

And, Mr. Secretary, as you may know, I am a co-chair of the nonpartisan Hurricane Irene Coalition here in the House, and my priority, as is theirs, is to ensure that we, and in our case the Hudson Valley, has the fullest possible access to the Federal funds that we need to recover from Hurricane Irene and Tropical Storm Lee.

Over $400 million in disaster aid has been made available through the Community Development Block Grant (CDBG) program, but, as you know, my home county of Westchester is being denied this help as well as their normal CDBG funding due to an ongoing dispute with HUD over what can reasonably be described as minor, but punitive terms of a recent settlement that was made before the current county executive took office. And that is despite the fact that Westchester has assured funding in good faith for over 700 units of affordable housing in a county that has a limited amount of land, and we have a lot of open space, which is good for the environment.

So, Mr. Secretary, I am asking as a member of the Hurricane Irene Coalition and as the Representative for a good part of Westchester County that you please work with Westchester County to provide the critical recovery funding that the county needs and deserves. And I thank you, sir, and look forward to your testimony.

Mr. Chairman, I yield back.

Chairman BACHUS. I would like unanimous consent for the record to reflect that there is a nonpartisan caucus on Capitol Hill. So thank you.

At this time, Mr. Dold for 1½ minutes.

Mr. DOLD. Thank you, Mr. Chairman. Certainly, I want to thank you for holding this hearing, and, Secretary Donovan, thank you for being here.

I think we all share a common objective, which is a more sustainable and more effective mortgage finance system, and regardless of political party, most of us would agree that such an improved system should have three primary components: first, to promote the private sector as our primary mortgage financing source; second, to restore long-term stability to the housing sector, and third, to protect taxpayers from future bailouts.

After already paying for over $100 billion in Fannie and Freddie losses, and with potentially hundreds of billions more in coming years, taxpayers also remain exposed to potentially large FHA losses because the FHA guarantees over $1 trillion of mortgages while maintaining only a tiny fraction of that number in insurance reserves and other resources.

Solving this problem, I think, is absolutely critical for taxpayers, for current and future homeowners, and for our economy as a whole. And so I am concerned when I see additional solicitations coming out—and there is one over here that I just saw that is talking about trying to get additional loans with a FICO score of only 580—these are a concern for me. And I think what we have to do is come together to try to make sure we are shoring this up for the American taxpayer and for future homeowners.

I look forward to your testimony here today. Thank you so much for being here, and I yield back.

Chairman BACHUS. Thank you.

Are there any other Members on the Minority side or any other maybe ranking members-in-waiting who would like to make an opening statement? No? Okay.

At this time, Mr. Schweikert is recognized for 1 minute.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Mr. Secretary, I look forward to hearing the testimony. I am operating under two premises: one, that a shock in the FHA loan system would be horrible to the real estate market, particularly when you are from Arizona, but the second part of that premise is you are in violation of the law. Looking here at the statute that you shall maintain 2 percent, I look forward to learning why I am wrong in the way I am reading this statute.

The second thing is also going to the actuarial report, and please forgive me if I missed it. I am trying to get a good definition and breakdown of properties and mortgages on your assets side. What is the breakdown? How much is actually held in REO properties, and how much is actually held in paper? And as my good friend Mr. Dold here just mentioned, this probably isn't you, this is maybe a correspondent lender, but when you get an email soliciting an FHA loan with a 580 FICO score, it makes you a little nervous. Of if you are going to grow your way out, do you grow your way out with higher-risk loans?

Thank you, Mr. Chairman. I yield back my time.

Chairman BACHUS. Mr. Canseco is recognized for 1½ minutes.

Mr. CANSECO. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for being here today.

Yogi Berra once said, "It is deja vu all over again." The latest actuarial report on the state of the FHA's insurance fund is reminiscent of warning signs we saw from Fannie Mae and Freddie Mac last decade. Even though FHA has been below its statutorily required capital ratio for 3 years, it now has exposed taxpayers to over $1 trillion in liabilities, and the agency now guaranties almost one-third of new mortgages in the United States.

Even a cursory look over the latest report brings into question many of FHA's projections about the health of the housing market and its ability to cope with future losses. Putting taxpayers in such a risky position is unacceptable, and it is a stark example of the consequences of the decades-long foray of government meddling in the housing market.

Today's hearing is of extreme importance, and I look forward to hearing from our witnesses on this matter. And I yield back the balance of my time.

Chairman BACHUS. Thank you.

Without objection, if any Members want to submit written statements, they will be made a part of the record.

If there are no further opening statements, at this time I would like to welcome Secretary Donovan and Mrs. Galante. The Secretary has a hard stop of 12:30, but I understand that the Commissioner can stay longer if Members have questions.

And so at this time, Mr. Secretary, you are recognized for 8 minutes.

STATEMENT OF THE HONORABLE SHAUN DONOVAN, SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY CAROL GALANTE, ACTING COMMISSIONER, FEDERAL HOUSING ADMINISTRATION

Secretary DONOVAN. Thank you, Chairman Bachus, and members of the committee for this opportunity to testify on the status of the FHA MMI Fund and the Fiscal Year 2011 actuarial report. But before I begin, I want to say a quick word about Ranking Member Frank, who announced his retirement this week. Given that he has never been exactly the retiring type, I am sure that the Congressman will continue to be the passionate and effective advocate for families on Main Street that he has always been.

Mr. Chairman, this report arrives in a significantly different environment from the one that we faced upon taking office. Then, our economy was shedding over 800,000 jobs a month, housing prices had fallen for 30 straight months, and foreclosures were surging to record levels month after month. Today, nearly 13 million homeowners have refinanced their mortgages since April 2009, putting nearly $22 billion a year into the hands of families and our economy. And with recent changes from FHFA, more refinances are on the way.

Today, because we provided responsible families opportunities to stay in their homes, the number of families falling into foreclosure is down 45 percent since early 2009. More than 5.3 million mortgage modifications have been started since that time. Central to this progress has been the FHA, which has undertaken the mission that Congress set for it after the Great Depression by taking over 1 million loss-mitigation actions to help families keep their homes, and helping 2.25 million first-time homebuyers realize the dream of homeownership, 56 percent of all first-time homebuyers in the last 2 years and 60 percent of African-American and Hispanic homebuyers last year alone. And as the actuarial report we discuss today finds, while we have been through the second worst housing downturn in the history of the country, FHA, unlike many other institutions, retains a positive fund balance, and the current book of business is strong.

Specifically, the actuarial reports insurance on loans booked since January 2009 posts an estimated net economic value of $18 billion, with the new 2012 book of business expected to add $9 billion alone. It reports that although the capital reserve account is $4.7 billion, FHA's total reserves stand at $33.7 billion, $400 million more than in 2010.

That the FHA has been able to weather this storm thus far to date is no accident. Indeed, with the partnership of Congress and this committee, we have been able to put in place the most sweeping reforms to credit policy, risk management, lender enforcement, and consumer protections in FHA history, reforms, as this actuarial report makes clear, that have produced real results. With your help, we have been able to increase premium rates 3 times under this Administration, yielding significant added revenue to the fund. We have also put in place a two-step FICO floor, which required those with low credit scores to contribute a minimum downpayment of 10 percent. Only those with stronger credit scores have remained eligible for FHA-insured mortgages with the minimum downpayment. This approach is based on FHA data that clearly shows that the success of a borrower depends on a combination of factors that include the loan to value, but not that alone.

The changes we have made have significantly improved the quality and performance of FHA loans. Where nearly half of FHA borrowers had credit scores below 620 in 2007, today the average FHA credit score across all borrowers is over 700 for the first time in FHA history. For home purchase loans originated in early 2011, early payment default rates are less than one-sixth what they were in early 2018, and for streamline refinance loans they are one-twelfth of what they were at the peak before President Obama took office.

We have taken other steps to protect the fund as well, including critical enhancements to lender enforcement, withdrawing the approval of over 1,600 lenders to participate in FHA programs, more than 4 times the number during the entire tenure of the previous Administration. With these actions, we are sending lenders a very clear message that if you don't operate ethically or transparently, we won't do business with you, and we will not hesitate to act.

Mr. Chairman, the collective impact of these efforts cannot be overstated. Indeed, were it not for these reforms, many of which this committee has helped make possible, FHA would be seriously in the red today. And on the strength of these new books of business, not only does the actuarial report find the fund retains positive capital today, it projects that FHA should be able to rebuild reserves to the congressionally mandated 2 percent threshold quickly once markets across the country exhibit sustained growth. Indeed, using base case projections based on Moody's Analytics forecast, the actuary expects capital reserves to reach 2 percent again in 2014, sooner than was projected just last year.

Of course, for all this progress, very serious challenges remain. Like any other organization in the housing-finance sector, the actuary finds that FHA's finances are very closely tied to home prices, which have been broadly stable since we took office, but weaker than expected in 2011. In particular, it found that FHA's older books of business underwritten during the bubble years of 2000 to 2008 will continue to produce substantial losses of more than $26 billion. It reports as many as half of the highest-risk loans insured at the peak of the housing bubble will ultimately result in a loss for the FHA, with more than one out of every four loans insured in 2007 resulting in insurance claim and losses of close to $10 billion for the 2008 book of business alone.

That is why we continue to pursue additional reforms that protect the taxpayer, support the housing market, and meet the FHA's historic mission of helping underserved borrowers. In the very near future, we expect to publish an indemnification rule to hold lenders in FHA's lender insurance program responsible for loans that were improperly originated or in which fraud or misrepresentation were involved. In addition, we will soon publish a rule that reduces allowable seller concessions to protect the MMI Fund from risks associated with inflated appraisal values.

Now that we have these actuarial results, we are carefully examining a range of additional steps to further strengthen the fund, including enhancements to our loss-mitigation protocols and whether additional premium increases are necessary. We expect to announce these next steps in our proposed Fiscal Year 2013 budget, and we will work with Congress as we have throughout.

We must also continue to shrink government's footprint, a key goal of the Administration's White Paper on the future of housing finance, and a process that I am pleased to report has already begun at FHA through our premium increases and underwriting changes. Indeed, while FHA's volume grew dramatically during this crisis, in 2011, FHA loan volume was down 34 percent from its peak in 2009.

FHA's current market share of mortgages is 14 percent and declining for the first time since 2006. During these uncertain times, as we carefully manage the balance between helping the market recover and working to bring private capital back, this represents important progress.

And so, Mr. Chairman, while none of us can predict what the future will hold, what we do know is that these new loans we are making are the strongest in FHA history. But given the continuing fragility of the market, we must continue to be vigilant and prepare to take additional steps to protect the taxpayer. As it has been since the outset of this Administration, that remains our goal today.

Thank you.

Chairman BACHUS. Thank you, Mr. Secretary.

[The prepared statement of Secretary Donovan can be found on page 89 of the appendix.]

Chairman BACHUS. Mr. Secretary, the Obama Administration's White Paper entitled—and you referred, I think, to that without naming it—"Reforming America's Housing Finance Market" that was released in February indicated that the goal was to encourage the return of private capital and to reduce the risk to American taxpayers, but looking at the Fiscal Year 2011 actuarial report from FHA, it assumes that the FHA market share—it assumes a market share of no less than 20 percent all the way to Fiscal Year 2018.

Do you know why this is? And won't that elevated level of FHA participation in the housing finance market discourage the return of private capital to the housing financial sector?

Secretary DONOVAN. Mr. Chairman, you are exactly right. The report laid out a series of steps, not just for FHA, but for Fannie Mae and Freddie Mac as well, to shrink their market share. The most critical steps there were to increase the cost of FHA insurance and the guarantees that Fannie Mae and Freddie Mac provide to encourage more private capital to come in, and we have started down that path. As you know, with authority granted by this committee, we have raised premiums 3 times. They now stand at the highest level in FHA history. And, in fact, it has begun to have results. As I just mentioned, we have seen our market share shrink from about 17 percent last year to 14 percent this year, and the latest quarter shows it continuing to shrink.

In addition, we proposed in the President's proposal for the budget compromise that was reached this summer to increase premiums for Fannie Mae and Freddie Mac. I know that you have supported that as well, and that is a step that we are working on with FHA.

In addition, we proposed, and we continue to believe, that loan limits not just for the GSEs, which have come down, but for FHA need to come down and return to their more historic levels so that we can ensure that private capital does return. So we have started on those steps, but we will continue to take steps going forward to make sure that we do everything we can to bring private capital back to the market.

Chairman BACHUS. Thank you.

The Fiscal Year 2012 funding bill that the President just signed and, of course, the Congress passed, reinstated the high loan limits for FHA. And, of course, I did not support that, and I don't think the President or the Administration supported that. First, I would like your comments on that. And second, it didn't include Fannie and Freddie. So my real concern, or another concern I have, is what effect will that have on business flowing to FHA from Fannie and Freddie?

Secretary DONOVAN. We stated publicly in the White Paper that you have referenced that we believed that the loan limits should have been allowed to expire, and I think if you look at my public statements, consistently, as I have said today, we continue to believe that the loan limits must come down.

I do think you point out something important, which is that the effect of having for the first time in history higher loan limits on FHA compared to Fannie Mae and Freddie Mac could produce the results that would have more business come to FHA than we have expected, particularly on the purchase side. We will need to see what happens there. And part of what we are looking at in terms of future steps is how we should price premiums and other policies. And I mentioned in my testimony that we expect in our budget proposal for 2013 to have specific proposals about how we move forward with these loans.

Chairman BACHUS. Thank you. I do think that could cause problems, and I think you agree.

Secretary DONOVAN. Mr. Chairman, if I could, one important point I want to make here is that those high-balance loans, the loans above our old loan limits, represent about 2 to 3 percent of our loan volume in terms of dollars—I am sorry, in terms of number of loans and about 6 to 7 percent in terms of dollar volume. And the evidence we have, albeit early evidence, is that those loans are lower risk than other loans that we are making. And so, therefore, I don't think the issue is that those loans pose a significant risk to the taxpayer or the fund. The real issue is about how we encourage private capital to come back while making sure that we continue to support the market through this crisis.

Chairman BACHUS. Thank you. I agree.

Mr. Gutierrez?

Mr. GUTIERREZ. Thank you.

Secretary Donovan, we have seen in the press—The American Banker: "Banks Likely to Gain FHA Relief Under Foreclosure Servicing Settlement"—that the FHA is potentially playing a role in the robosigning settlement between the servicers and the State attorneys general. It sounds like the FHA might be letting servicers off the hook for breaking FHA rules and failing to work with borrowers to keep them in their homes by waiving the FHA's right to deny a servicer's claim and enforce a penalty for an improperly conducted foreclosure.

Can you comment on this? And do you think this kind of settlement would be appropriate?

Secretary DONOVAN. Congressman, I want to make sure this is absolutely clear: It is exactly the opposite. We began an in-depth investigation of the servicing practices of our larger servicers. We found significant problems with the way that they were handling servicing, specifically their loss mitigation as well as other steps, the robosigning and other problems that you all have heard so much about, and began discussions with fellow agencies as well as State attorneys general, who also found similar problems with the way loans were being handled. And so the discussions that we have been having are about holding those servicers accountable for those practices, and, first of all, making sure that the taxpayer is compensated.

And, in fact, one of the things that can help the FHA fund to recover to a higher capital level is to recover where—not only on servicing, but on origination and other places where mistakes were made, where loans were originated or serviced against FHA requirements, as well as to get help to borrowers.

So any release that we would provide would be in exchange for significant penalties as well as to help homeowners who were wronged by those practices. That is what we are pursuing.

Mr. GUTIERREZ. And that is why I raised the question, and maybe American Banker just got it wrong. It is not like they always get it right.

I want to ask you this question because that is our responsibility. If a mortgage servicer, a bank, an originator of the loan didn't help the American family stay in the home, and did not go through all of the mitigation, and didn't or did robo, or didn't do anything, just let it sit out there, then you could simply say, yes, you can make an insurance claim; am I right? They can make an insurance claim, but if you find they didn't follow the rules, you can simply deny the claim and then penalize them 3 times the total cost—

Secretary DONOVAN. That is correct.

Mr. GUTIERREZ. Are you still committed to carrying that and having that as a powerful tool when we deal with the mortgage servicers?

Secretary DONOVAN. Absolutely.

Mr. GUTIERREZ. Because I think it is important that we all understand that the insurance is insurance, but you have to follow the rules of the insurance. And we know that they didn't follow the rules in many cases, and that is why we have the pending litigation across the country.

I believe that kind of settlement is important because it sends a message that just because you have an FHA-insured loan, it doesn't mean you are going to get the money. Because what we have found—and I don't know if you have any evidence of this and I would like to hear your comments—in just the normal practice of reviewing is that homes stay out on the street and the banks do nothing to keep people in the homes. They don't mitigate. They simply send you a letter and then you send them money and then they want on and then they are going to foreclose. They don't help anybody. And secondly, they simply leave the homes.

In Chicago, for example, the city council had to pass legislation against the banks saying, well, if you are just going to have all these abandoned properties out there, we are going to charge you for boarding them up and for keeping them clean and we are going to have to fine you. We found that. Do you find the same situation to be true across the country?

Secretary DONOVAN. As I said earlier, Congressman, we have found significant problems with servicers not following our requirements on loss mitigation. And I am proud to say that FHA has been a leader in correcting those and ensuring that we help families stay in their homes.

Mr. GUTIERREZ. And I am with you. I support you. I think you are at the helm and are doing a good job. I just want to raise this issue because I know what you have done on loss mitigation. I congratulate you and I thank your staff for keeping American families in their homes. But I also want to say to all of those mortgage servicers out there that you are going to continue to penalize them, as they try to submit a claim and they didn't follow the loss mitigation and they didn't follow the procedures, you are going to deny that claim and you are going to try to go after them for 3 times the amount.

Thank you so much.

Mr. HUIZENGA [presiding]. The gentleman's time has expired. With that, Mr. Miller of California is recognized for 5 minutes.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. Secretary Donovan, I am glad to hear that you are holding lenders accountable. When they don't use reasonable underwriting standards and do their job, they should bear the loss. I am also, I guess, relieved to hear that my argument that the loan limits in high-cost areas are safer loans. But you have justified that they are. But there is no doubt we want to get the private sector money back into the marketplace. That has been the goal all along. And the drop in recent conforming loan limits identified by many economists is a test for the private sector to see if they are willing to step forward and fill the void. Do you have any evidence the private market is filling this void created by this at this point?

Secretary DONOVAN. I think there is some evidence that that is beginning to happen. Certainly there have been, in the jumbo loan space, some securitizations, some steps forward. Mortgage insurers are, some of them at least, coming back into the market more. And I do think that we need to continue to take steps that I talked about before to ensure that we encourage it. I think it is clear that we certainly haven't returned to a fully healthy market at this point and that we need to continue to take steps to encourage private investments to come back.

Mr. MILLER OF CALIFORNIA. Some have made the argument to get everybody out of it on the government side. If the private sector was the only game in town in 2007 without a government-backed entity, what would have happened?

Secretary DONOVAN. I think it is important to recognize that Congress established FHA to be a countercyclical force. So the fact that our market share grew in the wake of the crisis was not, as some may have suggested today, a plan on behalf of this Administration or something that we took affirmative steps to take.

Mr. MILLER OF CALIFORNIA. But if you hadn't been there, what would have happened?

Secretary DONOVAN. I think it is clear that had we not been able to step in and provide liquidity in the market, the housing crisis would have been deeper, there would have been more significant declines in home prices, more foreclosures, and frankly more losses for the taxpayer.

Mr. MILLER OF CALIFORNIA. And the taxpayers own homes, last time I checked.

Secretary DONOVAN. To be clear—and this is a critical point in this hearing today—the actuary predicts the loans we made from 2000 to 2008 will lose $26 billion for the taxpayers. Loans we have made since 2009 will make $18 billion for the taxpayers. So it is very important to recognize that the threat to the fund is from those legacy books of business and what we need to do is ensure that we minimize the losses from those. It is not a problem of the new loans that we are making, which are predicted to be profitable, even under the most dire economic circumstances predicted in the various models that the actuary looked at.

Mr. MILLER OF CALIFORNIA. If we, as some would like to do, end all government guarantees today, how would that affect the overall U.S. economy, in your opinion?

Secretary DONOVAN. I think we have been clear in our White Paper which does advocate shrinking the government footprint, but we have to do that in a careful, measured way.

Mr. MILLER OF CALIFORNIA. As the private sector backfills.

Secretary DONOVAN. So that the private sector can come in, and not to expect that is going to happen overnight. And I think consistently in a range of proposals that we have seen, that is something that Congress understands and that is generally understood, is that this will be a process that will take place over time and not something that we can expect, given the depth of the crisis to happen immediately.

Mr. MILLER OF CALIFORNIA. What are the barriers you see as it applies to the private capital we are entering into the market, in the secondary market for home loans today?

Secretary DONOVAN. Clearly, confidence and a stronger economic recovery overall is a critical step. That is why the President has been so focused on getting the American Jobs Act passed. That is why as part of the American Jobs Act, he proposed a project rebuild that would specifically deal with the overhang of foreclosed properties, put 200,000 construction workers back to work fixing up those properties, but also ensure that they actually—rather than depressing home values in their communities, they help to raise home prices by getting fixed up and being resold. That is a critical step that we can take.

A second one I would say is to remove some of the uncertainty that is holding back lending today. And that is another reason why we have been pursuing these discussions around robosigning and other problems. We have to resolve those and get clear, fair, strong rules of the road in place that require servicing and other steps to be taken that really make sure that it is clear what the responsibilities of the lender and a servicer are going forward, rather than the lack of clarity that we had that led us into the crisis.

Mr. MILLER OF CALIFORNIA. Thank you very much. I yield back.

Mr. HUIZENGA. At this point, Mrs. Maloney of New York is recognized for 5 minutes.

Mrs. MALONEY. Thank you. Obviously, saving more loans from going into foreclosure is key to reducing losses to the FHA insurance fund. And a New York Times editorial—I believe it was this weekend—that I read stated that there are 14.7 million American homeowners underwater on their mortgages. Unfortunately, 1.6 million will likely lose their homes to foreclosure. But the editorial states that there are at least 1.6 million who have had a temporary setback in their lives, whether it is a health condition or a loss of a job, and that their homes can be saved if a loan modification is done.

The key to making this happen is the servicers reaching the borrowers to advise them of their options, particularly loan modifications. And I know from a recent OGR hearing from another committee on which I serve that the GSEs are doing a lousy job of borrower contacts. Fortunately, HUD has a regulation on its books since 1992 requiring servicers to make face-to-face contact with the borrowers after the 90th day of delinquency.

And I must say, in New York what has been the most helpful is when we have these conferences with the borrowers, with the people in need, with government services and try to put people face to face to help them stay in their home and to help the borrowers keep the houses and really to save the American taxpayers money. What more can we do to really enforce that regulation of forced face-to-face contact, of working to help the people stay in their homes? Are you enforcing that regulation? And could you give us some insights into why the servicers are not responding, why they don't work to help them stay in their homes? We get reports all the time when people do lose their homes that the servicers never even contacted them. They just came in and foreclosed on them. So should we try to give them an economic incentive so that they would work harder, have face-to-face contact, try to work it out? What can we do? Why are they not doing it? And are you enforcing that regulation?

Secretary DONOVAN. Congresswoman, I think partly this goes back to the discussion we began with Congressman Gutierrez, which is we did find substantial problems in lenders not meeting our requirements for reaching out to borrowers, for offering them the right tool to be able to stay in their homes. So we have both through enforcement measures and technical assistance, working closely with those lenders, we are enforcing those regulations and have seen improved results. At this point, not only have we reached about 1.2 million homeowners to help them stay in their homes through loss mitigation activities, but we have improved the success of it to the point where 2 years, later 95 percent of those homeowners are still in their homes. So we are making progress. I think we can go further. We continue to push.

We are also, through servicing settlement discussions that we are having, looking at requiring write-downs that you talked about and improved modifications that would help more families stay in their homes.

The last thing I would say though is housing counseling is a critical piece of the puzzle here. What we see is that recent evidence shows a homeowner is twice as likely to be able to stay in their home if they get housing counseling assistance, if they get that face-to-face help from a housing counselor.

We were very disturbed when $88 million was cut from HUD's budget last year. We were able to work with the Appropriations Committee this year to get, not all of that funding, but a significant portion of that funding restored. And we have been working closely—and I give Carol real compliments here—to improve our housing counseling operation. We have cut the amount of time to get funding on the streets by 83 percent through our competitive processes. We already have our housing counseling notice out and available for the 2012 funds we just got. So we are really trying—we are doing a lot to improve that process, and that funding will be critical as well.

Mrs. MALONEY. I totally support your funding request, and it has been part of our recovery.

Also, could you comment either in writing or in the brief time I have left on the economic development programs that HUD has? I know the focus is housing. But particularly when I was on the city council, your 220 program would help build sort of economic models. I know at that time, it even made money. Can you talk about that program? Is it still around? Is it working? Is it helping with economic development?

Mr. HUIZENGA. The time has expired, but go ahead and answer that question.

Secretary DONOVAN. I would be happy to follow up afterwards with more specifics on the program. We do continue to have that program available. I would also say, in the project rebuild portion of the Jobs Act that the President proposed, we propose to expand our neighborhood stabilization activities that have been so successful in the residential area to include up to 30 percent that could be used for commercial and nonresidential buildings or properties to support economic development as well, particularly in neighborhoods that have been hardest hit by the housing crisis. And that is an important tool as well.

Mr. HUIZENGA. With that, Mr. Garrett from New Jersey has 5 minutes.

Mr. GARRETT. I thank the Chair, and again, I thank the panel for being here. And I want to thank the panel also and Mrs. Galante, who testified before the Senate Banking Committee, if I am not mistaken, speaking for the Administration, opposed the recent increase or maintaining the level of FHA loan limits. I agree with you on that. And if I understood your testimony correctly, I appreciate that. My only regret, as I said before, was that the Congress went ahead with their decision on this prior to totally digesting the entire report that you all had there, as far as the condition of the fund right now.

First of all, just a basic question. So you might want to say, look at the FHA, you are saying in two books, the old book and the newer book. And the old book is the one where you are losing money on it; it is bad. And the newer book is a good book and you are making money on it. So things will be good as that book goes forward. Is that basically a summary?

Secretary DONOVAN. Congressman, I want to be clear about this, because I think it has come up in other comments as well. We have significant concerns about the level of the reserves at this point.

Mr. GARRETT. I understand that.

Secretary DONOVAN. The actuary does predict that the fund will stay positive. But there is a serious risk and we need to take steps to protect against it.

Mr. GARRETT. I guess my question is, if things are getting better based upon the new book—in other words, you are saying you are going to be able to make money on the new book, why don't you just significantly increase the size of your new book or why isn't the private sector entering into that market sphere? If you are able to make money on it, why isn't the private sector able to make money on it? And why are they leaving it all to you if it is such a good book?

Secretary DONOVAN. Specifically, I believe—and it goes back to the comments I made earlier—that there are a series of barriers to the private sector reentering that include a lack of clarity around enforcement, servicing, potential buy-backs, and a range of steps that need to be clarified and established so that more private capital does come in. I would be clear—

Mr. GARRETT. I only have 2 minutes.

Secretary DONOVAN. Our market share is declining and that is important evidence, I think, that the steps that we are taking to shrink our footprint are beginning to have a real effect.

Mr. GARRETT. Let me get into another issue and get into the weeds on an accounting issue that I talked about. I am a member of the Budget Committee and one of the areas we are looking at is how the FHA is scored. Currently, even though the GSEs and FHA are both part of the government and you both are taking on risk, they are scored differently. The scoring on the GSE book is scored by including the market risk of holding loans, while the FHA book, on the other hand, is scored under the Federal Credit Reform Act, which does not include the market risk. What this means from a practical point of view is that the GSE book looks better than it does with less volume, and the FHA book looks better than it does with more volume. Some have insinuated this has been done on purpose by the Administration and have opposed a change of the rule because it basically makes the GSEs look better as they shrink down and makes the FHA look better as they increase.

On this accounting rule, do you support rectifying this difference and assuring the taxpayers are provided some transparency as to the actual risk tat you incur and are taking through these programs?

Secretary DONOVAN. First of all, Congressman, we obviously follow the law in terms of Federal credit reform and it is up to Congress to determine how we—

Mr. GARRETT. And what is your recommendation to Congress? I only have a little bit of time.

Secretary DONOVAN. I think you are talking about the fair value accounting that CBO has recommended.

Mr. GARRETT. Right.

Secretary DONOVAN. We believe there are a number of steps in CBO's way of looking at this that are important. We have in fact begun to incorporate different changes to our modeling in a number of those. There are portions of it, however, that we really don't think apply to FHA.

Mr. GARRETT. Why is that?

Secretary DONOVAN. Simply because our cost of credit and a range of other things are different from the way—essentially what they are recommending is that we look at it as if we sold off FHA to the private sector and how would it be modeled and valued.

Mr. GARRETT. And is that the fair way of—

Secretary DONOVAN. The fact is that there are many things that are different about the way the business operates, both in terms of the need for return on capital. We don't have a need for a return on equity. That would overstate the costs. There are a number of other things that are just different about the way we operate. We are not a profit-oriented institution. We don't have shareholders that need a return, and those portions of it simply don't make sense for the way you look at FHA. And frankly, they are not required by the law.

Mr. GARRETT. Right. I understand that it is not required. That is why we need to change the law and that is why we are looking for you to give encouragement to Congress in order to make those changes. I see my time is up.

Mr. HUIZENGA. With that, Ms. Velazquez for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Welcome, Mr. Secretary.

Secretary DONOVAN. Thank you.

Ms. VELAZQUEZ. Let me take a moment to thank you for your leadership and your foresight in dealing with this massive housing disaster that you were confronted with. And I want to thank you on behalf of the 13 million families who have been able to keep a roof over their heads and everything that you are doing to assist those who are at risk of foreclosure, representing the 99 percent of this country.

So my question is, Mr. Secretary, during the housing bubble, the FHA insured less than 500,000 mortgages. After less than 5 years, FHA's obligation has expanded to cover over 1.7 million mortgages, more than a threefold increase. Did the FHA take any steps to prevent private lenders from shifting the risk of underperforming loans to the FHA and therefore taxpayers?

Secretary DONOVAN. It is a very important question. And we were very concerned when we came into office that risk management was not strong enough at FHA, that we had not taken sufficient steps to make sure that we weren't going to get those very same subprime lenders that had caused such damage to shift over to FHA. And so we appointed the very first chief risk officer in the history of FHA. We have created a whole organization, risk management organization under that chief risk officer that has taken important steps. We instituted a whole set of underwriting changes which have improved the quality of our book. We have also taken substantial steps to increase our enforcement. I mentioned more than 1,600 lenders we have excluded from doing business with FHA, more than 4 times the number of lenders that the prior Administration had penalized in its entire 8 years. And so, we have taken a whole series of steps and others that are critical along those lines. And I really do think that is a big reason why the performance of our loans has been so much better over the last 2 years.

Ms. VELAZQUEZ. Thank you. According to the HUD report, the MMI fund is expected to become solvent and will return to the congressionally mandated 2 percent capital ratio by 2014. Mr. Secretary, is this projection based on home values increasing over the next few years? And if that is the case, how would the FHA protect taxpayers if home values do not rise as expected, causing the MMI fund to seek help from Treasury?

Secretary DONOVAN. Very, very important. And just to be specific, the actuarial report predicted that home prices would decline in 2011 by 5.6 percent, and then would begin to rise about 1 percent, 1.3 percent next year. And that is sort of the base case that it projected on. And based on that, it projected that we would recover to the 2 percent capital ratio by 2014. Obviously, none of us has a crystal ball, and there is a real risk that home prices could perform worse than that, and the actuary looks at a whole range of scenarios there.

To ensure that we have protection against that, we are looking at a series of steps. I laid out five different steps in my written testimony, including premium increases, and further steps on lender enforcement. But I think it is very important for the committee to understand the balance here. Given that the actuary predicts that under any economic scenario that they look at, the new loans that we are making are profitable, given that our premiums are already at the highest level that they have been in the history of the FHA and given that the losses are really coming from old books of business, we have to balance any premium increases or other steps that we might take on new loans against both the fairness of that, given that they are already profitable, and the fact that it has some risk to the housing market more broadly by limiting the number of people who might purchase homes and pushing home prices down further.

So what we need to look at as well is how do we recover what we should be recovering from the older loans? And that means increased lender enforcement and other steps that we are looking at as well.

Mr. HUIZENGA. The gentleman's time has expired. With that, Mr. Neugebauer from Texas for 5 minutes.

Mr. NEUGEBAUER. Thank you. Secretary Donovan, it is good to see you again.

Secretary DONOVAN. You, too.

Mr. NEUGEBAUER. I want to go back to something I said in my opening statement. And maybe in the conversation you and Mr. Garrett were having, I think you all were talking about market share. But what I want to talk about is something you were just alluding to, which is that your new business is priced differently than your old business was because it turns out your old business probably wasn't priced appropriately because you didn't have enough money to cover that. And so now, the fund levels would be much worse than they are today if you hadn't had the fairly substantial increase in market share. Would you say that is true?

Secretary DONOVAN. I think there is no question that the quality of the new loans that we are making has helped balance losses on the old loans. As I said earlier, the Congress set us up to be countercyclical, and so this is not something that we intended. In fact, we are working to shrink our market share, and that is beginning to have an effect. But certainly, those new loans are balancing losses from those older books.

Mr. NEUGEBAUER. Providing the profit and the cash flow to sustain the losses on those. And so one of the questions that I wanted to ask you about you—putting these new risk management tools in place, it raised your guarantee fees. Are you doing locational risk analysis? Because obviously, there are pockets where if you are looking at—as you said, the studies showed maybe a 5 percent additional decline in prices. But there are other areas of the country that, as I am sure you looked at—that probably could actually have more than a 5 percent decrease, further decrease in prices. So when you are looking at making loans in those areas, are you saying—are you increasing the G fee or are you saying, you know what, we may not want to be making 97 percent loans in that area because of a downside. Is that a part of your risk management?

Secretary DONOVAN. Yes. Congressman, I would love to be able to have a way of knowing what is going to happen in the individual housing markets and the national housing market. If you know someone who could help us do that with precision, that would be a wonderful tool. The truth is that there are not great ways of knowing what is going to happen a year out or 2 years out at the national level, much less at the local level.

We work with appraisers. We have very clear appraisal techniques. We have been trying to improve those to try to get to real market value and to look at the kind of things that you are talking about. Certainly, we have gone to a disaggregated, more geographically specific set of home price indicators in the modeling. That is one of the improvements that we have made. But the truth is—and nobody is able to do this, to get to very precise, geographically specific pricing. The most important thing we can do—and this is what we did do—is to look at the risk factors for a particular borrower and to raise to 10 percent the downpayment requirement for riskier borrowers. And frankly, what we have seen since we did that is that our early payment defaults have declined by two-thirds in those riskiest loans. So the evidence is that the policy is really having a good effect.

Mr. NEUGEBAUER. Let's just go to the fact that your assumption—and I think it is kind of one of your best-case scenarios in the study was that you thought there would be an additional 5 percent decline in housing prices, right?

Secretary DONOVAN. Actually, it predicted that it would be 5.6 percent this year. Since that was done in June, we have another quarter of data and it is actually better than was predicted by the actuary. So it is likely at this point that 5.6 percent isn't quite as bad. But that was a prediction for this year.

Mr. NEUGEBAUER. Yes. So if you predicted that you are going to have a 5 percent decline in housing prices and you are making 97 percent loans, aren't we setting people up to being underwater? And when you talk about predicting the future of some of these locational issues, there are historical data that can show you what the inventory levels are in many of these locations, how long it takes to foreclose on properties in different jurisdictions. And to me, that is an important part of the risk analysis. But what you are saying is, we don't do that? Yes or no? We don't do that?

Secretary DONOVAN. What we are clearly looking at is what are the risks of different factors in underwriting. Downpayment is a critical piece, but it is one of a number of factors, and what we see on the performance of our high LTV loans—because we have excluded the highest-risk borrowers from doing that—is very, very strong performance. Early payment defaults are far lower for the highest credit score borrowers with high LTV than 10 percent downpayments with lower credit score borrowers.

So I would be happy to share with you more of the data. But what we are basing this on is real experience in realtime. And the performance there is strong enough. The other thing I would just say is—

Mr. HUIZENGA. The gentleman's time has expired. I will let you very quickly finish.

Secretary DONOVAN. I will just finish. We looked back at last year. If we had even gotten rid of the highest LTV loans on purchases, our estimate is that 10 percent of the borrowers in the entire country would not have been able to buy a home. So what we are balancing here, to be clear, is making as safe loans as possible but also not trying to do anything that would threaten the housing recovery. And frankly, anything that would hurt the housing recovery would do much more damage to the taxpayer not only at FHA but at the GSEs and elsewhere. And that is really the balance that we are trying to maintain.

Mr. HUIZENGA. Thank you. The gentleman's time has expired. Mr. Ackerman from New York for 5 minutes.

Mr. ACKERMAN. Thank you. I want to probe, if I can, for a moment and reflect on the philosophical differences within the committee as far as the role of the public sector and the private sector which I think is indicative of the same discussion in the country. There are those who would believe that the government or the public sector should play very little or no role in many aspects of public life, housing in particular in this case. It should be left up to the private market. And I think that is very reflective of our votes and our attitudes and our approach to things.

That being said, how much money do you make?

Secretary DONOVAN. Me personally? You mean FHA? Or do you mean me personally?

Mr. ACKERMAN. On your day job.

Secretary DONOVAN. I would say I make a fair salary. It is under $200,000.

Mr. ACKERMAN. It is about what we make, right?

Secretary DONOVAN. Yes.

Mr. ACKERMAN. And if you took a bonus from somebody, you would go to jail?

Secretary DONOVAN. We do have certain very, very small awards we can make to employees. I am not one of those who can get one of those bonuses. Yes.

Mr. ACKERMAN. So there is no incentive for you to gobble up business from other sources, is there? Other than getting an "attaboy."

Secretary DONOVAN. Based on the discussions of the committee today, I would say there are lots of incentives for me not to do more business.

Mr. ACKERMAN. But there are no financial remunerations?

Secretary DONOVAN. Absolutely not.

Mr. ACKERMAN. So you have no motivation for stealing clients or customers from the private sector and gobbling up their book of business, right? You have no reason to crowd them out of the market? You have no reason to see that their market share is less and your market share is larger, do you?

Secretary DONOVAN. None that I know of, Congressman.

Mr. ACKERMAN. And it is quite conceivable that in the private sector, people could get bonuses in exponential amounts, thousands of percentages if they wanted, larger than your salary?

Secretary DONOVAN. In fact, one of the problems I believe that led us into this crisis is that there was lots of compensation to mortgage originators to make bad loans.

Mr. ACKERMAN. And even in Fannie and Freddie before they were in conservatorship, they could get bonuses also?

Secretary DONOVAN. They could.

Mr. ACKERMAN. And yet, your business remained stable and you didn't get into any financial trouble and you didn't need a bailout while they did and had to be taken under the public wing and given taxpayer dollars to be steady?

Secretary DONOVAN. Thus far, although we continue to be vigilant, given the risks.

Mr. ACKERMAN. How come you did so well when they did so poorly in the private sector and those who are now under conservatorship?

Secretary DONOVAN. I think the main factor is that FHA continued to make plain vanilla 30-year fixed-rate fully-documented loans. It is why our market share shrunk to about 2 percent.

Mr. ACKERMAN. And you have no problem with your market share shrinking? You don't take it personally?

Secretary DONOVAN. That is what Congress intended us to do, from my understanding.

Mr. ACKERMAN. That is part of your mandate?

Secretary DONOVAN. When the private market is operating correctly, that we would need to do very limited business. That is correct.

Mr. ACKERMAN. So when you were established back after the Depression for the purpose of expanding into the brink, into the breach when there was a crisis within the system and you expanded to fill that role, those who said, Oh, my God; look what they are doing; they are stepping into the breach; and that is a dangerous place for them to be, how terrible, you were really fulfilling your role and your mission and your obligation, were you not?

Secretary DONOVAN. We believe so, yes.

Mr. ACKERMAN. And you would be very, very happy to have a smaller market share and remain stable and ready to fill that breach again once the problem has been resolved within the housing market?

Secretary DONOVAN. More than that, I believe we are taking affirmative steps to reduce our market share.

Mr. ACKERMAN. I want to thank you and your agency for doing the great job that you are doing and for standing ready to be the professional firemen that you are and withstanding the criticism of the people who say that you are preventing the good Samaritans from coming in and fighting the fire.

Secretary DONOVAN. Thank you.

Mr. ACKERMAN. Thank you very much. I yield back the balance of my time.

Mr. HUIZENGA. Thank you. With that, Mr. Posey from Florida for 5 minutes.

Mr. POSEY. Thank you, Mr. Chairman. Thank you for coming, Secretary Donovan. First of all, I would probably be remiss if I didn't compliment Buzz Osley in your Orlando office.

Secretary DONOVAN. Thank you.

Mr. POSEY. He has been a great asset to our office. He has been a great asset to educating the public in my district on how to stay out of trouble and, if you are in trouble with your mortgage, how best to handle it. Great, great job down there helping educate the public and mitigate losses.

Secretary DONOVAN. Thank you. I will let him know.

Mr. POSEY. A couple of questions. What are you doing to prosecute the fraud that you have discovered that helped put us in this undesirable position we are in now?

Secretary DONOVAN. We are working very closely with the Department of Justice. We obviously don't do the prosecuting ourselves. The Department of Justice represents us. We have active cases against a range of lenders. A good example of that is TBW, which was not only one of the larger FHA lenders but also a large

Fannie Mae and Freddie Mac lender. We discovered working closely with our Inspector General serious problems, including fraud, in the work that they were doing with FHA lending.

Mr. POSEY. Just because time is limited, I am going to ask if you would send me a memo and brief me on the number of cases and scope of it.

Secretary DONOVAN. Absolutely.

Mr. POSEY. And then, I will follow up with you on that.

Do you see any needed improvement in the REO process?

Secretary DONOVAN. One thing I would just mention related to the enforcement is we have legislative changes that we would like to pursue with the committee that we would love to work with you on to improve our ability to go after lenders and kick them out of the program when they are not doing their job. So that is an important next step.

Mr. POSEY. You will get 100 percent from both sides of the aisle on that, I promise you.

Secretary DONOVAN. And we have worked well with the committee on that.

Mr. POSEY. Back to REO. I only have 3 minutes.

Secretary DONOVAN. On REO, we are working closely with Fannie Mae and Freddie Mac. We asked for ideas from the public for new things that we could do to improve our REO processes. We expect by the first quarter of next year to be able to implement some new pilots around our work on REO to improve those processes.

Mr. POSEY. If you issue any bulletins on that, I would like to be kept in the loop. On paper, it is a pretty attractive process. On the ground, in reality, it is devastating. It is very inefficient. It causes you greater losses than you would sustain otherwise, and harms neighborhoods to a much greater degree than would otherwise happen if that process were streamlined, more effective, and allowed more people to participate in this. As I say, on paper it really looks good, but I think on the ground level, from my observation at least, it needs to be vastly improved and can't even wait a year for that.

What effect do you think it would have to make FHA loans, full recourse loans?

Secretary DONOVAN. I think you could argue about the amount but there is no question they would be substantially more expensive. And in exchange for that, I think there would be some potential improvement in performance. Various people have modeled it in different ways. It is hard to predict how significant that would be.

Mr. POSEY. If you have any data on that in your office, I would appreciate it if you would send that to me, if anyone has prognosticated what would happen there.

And I wonder if there is some way you might even make the awareness. I heard it said by many people, the point made by many people and most recently by former Senator Gramm that we hear a lot of people are upside down in their mortgages. And he compares that to somebody driving a new car off the car lot. The second they drive off, if they financed their car, they are upside down in their car, too. That doesn't mean it makes good sense to abandon the car and go buy another one.

I just wonder if there is some way you might initiate that in your education program. I know there are so-called financial advisors telling people, “Hey, if you are underwater, walk away.” And that really doesn’t help anybody at the end of the day. If people would hang in there a little bit better probably, like they do their with automobile, just view it a little bit differently. I just think there is a negative propaganda being perpetrated to a large part of the population and no positive information coming from the other way to put it into proper perspective, more reality.

I am sure you have read the book, “Reckless Endangerment”—that would have been a good title for a former Congress. But the authors of that book believe that the worst of this market is still ahead of us. We have been unable to get anybody from the Department of the Treasury to tell us whether or not they think we have bottomed out, to give us any real information. The people that we think are the most knowledgeable cannot give us that information. I would appreciate any insight that you have.

I see my time is up. Thank you, Mr. Chairman.

Secretary DONOVAN. I would be happy to follow up.

Mr. HUIZENGA. With that, Mr. Capuano from Massachusetts for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Secretary Donovan, do you have any idea approximately how many loans FHA currently has up there right now?

Secretary DONOVAN. The total value of our portfolio—

Mr. CAPUANO. The number of loans.

Secretary DONOVAN. —is over $1 trillion. The exact number—

Mr. CAPUANO. The number of loans.

Secretary DONOVAN. It is right about 7 million.

Mr. CAPUANO. About 7 million. I am just curious. Of these 7 million people, these are all first-time home buyers, is that correct?

Secretary DONOVAN. Not all of them are first-time home buyers. There is refinancing also available. That is a much smaller share of our business.

Mr. CAPUANO. So 90 percent of them are first-time home buyers?

Secretary DONOVAN. Our estimates are that of all the first-time home buyers who bought homes last year, about 56 percent used an FHA mortgage. So it is not only a huge share within our program; it is a huge share of the overall.

Mr. CAPUANO. So vast bulk of all FHA mortgages are first-time home buyers, people getting into the market, mostly young people for obvious reasons. I am just curious. I know that you don’t know the answer. But I would like at some point for some of your people to take a look to see how many of them, if it wasn’t for FHA, could afford a 50 percent downpayment and then afford to carry a mortgage over a 5-year period? And I ask that question because, and correct me if I am wrong—I know you have the staff back there who probably have great history in their minds—before FHA, wasn’t that the typical mortgage in America: 50 percent down and a 5-year repayment period?

Secretary DONOVAN. That was very typical before FHA. And still in many countries around the world, those are the types of terms.

Mr. CAPUANO. And the creation of FHA instituted the 30-year mortgage which we now come to take as a given, and they instituted the practice of limited downpayments, 20 percent, 10 percent, now down to 3.5 percent, whatever the number might be. Is that a fair historical memory?

Secretary DONOVAN. That is right.

Mr. CAPUANO. I ask that because I am not against the private market but that was what the private market did when there was no government involvement. The private market basically disallowed most people in this country—my guess is of the 7 million mortgages you have now, very few of them would ever have been able to put 50 percent down and pay a mortgage back at the rates that would have been required over a 5-year period. Very, very few of them, which is why homeownership has gone up in this country. I think it is a fair debate that we are currently having as a society where the level of homeownership should be. But I don't think anyone has the audacity to suggest that you go back to the 30 or 40 percent that it was before the FHA.

And I say that because all this discussion about somehow you have done something wrong is ridiculous if you believe that homeownership and middle class go together. I guess I do. And those who don't should turn to their own constituents and tell them to sell their house and rent.

The other thing I am concerned about—and I think you are as well—are some of the issues relative to the capital requirements, the reserve account. And I actually think that it is long overdue and well done to tie downpayment requirements and other requirements to FICO scores—not that I think FICO scores are the holy grail but you have to have something, and they are as good as anything. So I actually think it is a good thing. Just out of curiosity—I think you have already said it but I want to be clear—have the repayment levels improved now that you have increased the FICO score requirements?

Secretary DONOVAN. Our early payment defaults have dropped by two-thirds.

Mr. CAPUANO. So they have improved? Defaults have gone down as you have increased the FICO requirements?

Secretary DONOVAN. The other thing—and I have to thank the committee for this—the most serious problems we had, the worst loans were seller-funded downpayment loans. And those alone are estimated to be responsible for about $14 billion in losses and that was stopped by this committee just in the beginning of 2009.

Mr. CAPUANO. Is it also a fair conclusion that in the average home, the more valuable homes that you are allowed to do, the ones that are closer to your cap are the ones that have a lower rate of default? Is that a fair conclusion?

Secretary DONOVAN. Given that we haven't been doing those larger loans for very long, it was raised as we went into the crisis by Congress, we don't have definitive data but the early default performance suggests that those larger loans actually perform somewhat better.

Mr. CAPUANO. So that it would be fair as we are—because again I haven't heard any disagreement from you that the idea is to get the capital reserve up back where it is supposed to be so that everybody could feel better about this and the fact that you have raised these standards and narrowed down some of the scopes of who could get in, and you are raising that number, it would be fair I would think to do this statutorily to say—not just for you but for the next HUD Secretary, the next Congress to say, if those capital levels go down, then we will automatically trigger some of the things that you have already instituted. And if we do that and you continue on the course that you are on, kind of tightening it up when the reserves go low—not to get you out of the market but because no one wants a bailout, no one wants you to default, no one wants problems with FHA, we want you to be stable. Why shouldn't we just do this statutorily in some general way, exactly the types of things you have done and maybe a few more things as well?

Mr. HUIZENGA. The gentleman's time has expired. I will allow a very brief response.

Secretary DONOVAN. I would be happy to follow up. I think the only thing we need to be careful of is the balance between recovering on old loans that were the problem versus putting increased costs on new borrowers. And given that our premium levels are already at the highest level, I think making sure that we maintain that balance not just focusing on the underwriting of new borrowers but also what we are doing on old loans around enforcement is critical as well.

Mr. HUIZENGA. All right. The Chair will make a historical note that the FHA was created in 1934, according to the memo in front of me. And we will now go to Congressman Schweikert from Arizona.

Mr. SCHWEIKERT. Thank you, Mr. Chairman. I am glad someone had the memo. Forgive me for doing this, but there are just so many questions I would love to run through, Mr. Secretary. So we will try to pretend to do the lightning round. First off—and I think there may be an informational correction from the last bit of exchange of testimony. FHA is not restricted to first-time home buyers, correct?

Secretary DONOVAN. That is correct.

Mr. SCHWEIKERT. The way the last dialogue went, if someone was listening, they would think they would have to be a first-time home buyer and I want to make sure it is on the record that it is not that way. Also, you are talking about performance particularly on the higher end of your LTV, your loan limit performing pretty darn well. If we are walking into this environment where some of our regulators are actually doing the Qualifying Residential Mortgage (QRM) and the qualifying mortgage definitions, isn't that going to ultimately continue to inhibit or drive more business to FHA and stymie the creation of a private label in the S market?

Secretary DONOVAN. Just to be clear, first of all, I think we were talking about large balance loans rather than in terms of the performance, rather than LTV.

Mr. SCHWEIKERT. I was just using that as an example of loans that are performing well. So that would actually be—if you and I were going to go out and start our own private label mortgage, you and I are going to start a securitization business, that is probably where we would go first because we know it is performing well. But if I have a Qualifying Residential Mortgage and I have risk retention and all these other things over here, how am I ever going to compete with FHA?

Secretary DONOVAN. There is no question that there is an important balance that needs to be struck in the QRM between making sure that we don't repeat the mistakes of the past but at the same time creating a robust private market. So I think you raised an important tension. But for FHA, we have a range of mechanisms, including our premium levels and other underwriting, that have allowed us—and loan limits of course, which have allowed us to ensure that the private market can function very well.

Mr. SCHWEIKERT. Actually, that is really not true. You have your G fee, your fees and you do have loan limits. But because of the current loan limits, which my understanding is you weren't particularly thrilled with, there is no private market out there. Now a lot of that is there are uncertainties within Dodd-Frank and those mechanics. Please understand, I have had an FHA loan. I have sold—my brokerage firms over the years have probably sold hundreds, if not thousands of them. So it is not my opposition there. It is just it is sort of the mission creep in many ways, you are a huge portion of the market today.

Mr. Secretary, has your legal staff thrown out any warnings or concerns about the fact that you are well beyond this statutory 2 percent and any sort of recourse that either you, in your capacity, or as an agency, hold by violating the law right now?

Secretary DONOVAN. We have had a lot of discussions with the legal staff. My concern is not just on the legal side. It is on the business side that we need to take significant steps to make sure that capital reserve gets rebuilt. Just in terms of the specifics of the law, my understanding is that it requires that if FHA goes below the 2 percent, there be a plan put in place to ensure that the fund recovers as quickly as possible. Those are the steps that we have described. Those are the additional steps that I talked about that will be in our 2013 budget. All are parts of what is required by the law to put in place steps that will help the fund recover.

Mr. SCHWEIKERT. Mr. Secretary, why I am a little disturbed is because as I go back to previous years' testimony, it sounds very similar. We are going to build the plan. Please understand, I don't want there to be a shock to FHA where all of a sudden some legal opinion comes and you could have to stop writing loans or do this or that because I don't think the real estate market can handle that.

I want to bounce to something Mr. Posey said just because I think there might have been an exchange error there. And I think he touched on, what do you think would happen if FHA loans were full recourse, would that help your credit quality, would that also help us in some way where for many of us that have a concern, if someone gets an FHA loan—so I have what, 3.5, maybe 5 percent down and I somehow am able to get either a credit line or stacking a second instrument behind that, there is absolutely no equity—in many ways, you are incentivized to walk away from the loan. Should that trigger recourse on my first mortgage or deed of trust?

Mr. HUIZENGA. The gentleman's time has expired. I will allow the Secretary to answer.

Secretary DONOVAN. I would actually need some clarification on the question. I am not sure I am clear. I would be happy to follow up afterwards.

Mr. SCHWEIKERT. Mr. Chairman, may I have unanimous consent for 30 seconds?

Mr. HUIZENGA. Without objection, it is so ordered.

Mr. SCHWEIKERT. Right now, an FHA loan is nonrecourse, correct?

Secretary DONOVAN. Yes.

Mr. SCHWEIKERT. If I go and put a second loan behind that in most places, other than Texas—it is still nonrecourse. But I have chewed up what little equity was built in there and actually made it even more likely that I am going to default or there is going to be a higher loss ratio on it. Has there ever been discussion of policy on, if I stack up, if I use what little equity I have in the property that the first should become recourse?

Secretary DONOVAN. I have not heard extensive discussion of that. There has certainly been a significant amount of discussion about whether to allow second liens, how to ensure we don't get the same kinds of problems that we have had in terms of the stacking of debt in first, seconds, thirds in many cases. That has clearly been a significant problem and I think it is important that we have policies that ensure that doesn't happen going forward.

Mr. HUIZENGA. The gentleman's time has expired.

Mr. SCHWEIKERT. Thank you, Mr. Chairman, and thank you to the committee for your tolerance.

Mr. HUIZENGA. On behalf of the committee, you are welcome.

With that, Mrs. McCarthy from New York for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman. Thank you for having this hearing. And thank you for spending so much time with us, Secretary Donovan. This is a great concern for all of us on both sides of the aisle because we are dealing with an awful lot of constituents at home who are trying to get modified mortgages. I think there is only one—I am not going to mention the name—bank that has been working with us and they are the only ones that have actually modified a number of mortgages that we have been asked to help.

But something that I wanted to ask you about, especially what has been in the paper, with our veterans coming home from Afghanistan and Iraq and coming home to find that their house is in foreclosure when we have passed legislation to make sure that wouldn't happen. What can you be doing to protect these veterans coming home? Even though we have laws, but obviously—to me, whatever is the highest fine that you can give to these particular banks, it should be. And it should be.

Secretary DONOVAN. Yes. These examples are shameful. And we have worked closely where we have found examples of that in FHA. We have worked closely with the Department of Justice. They have brought a series of cases. I would be happy to follow up to get you background information on not only cases they brought but where they have won judgments against companies for that.

The other thing I would add, though too, is in addition to examples on the foreclosure, we have many, many servicemembers who are being hurt by being underwater and the inability—particularly when they are asked by the country to relocate to another base and they are stuck in a house that is underwater, they can't sell it, it hurts their credit rating, there is work that the Department of Defense has done, a set of programs that Congress has established that are very helpful in terms of making sure servicemembers aren't hurt by being underwater where they need to move as well. So that is another step that we could take that is very important.

Mrs. MCCARTHY OF NEW YORK. If there is anything that you think that we need to be doing even more so, please let us know because those who are defending this country and coming home—those who are lucky enough to come home uninjured, we can't let this one go.

Secretary DONOVAN. I couldn't agree more.

Mrs. MCCARTHY OF NEW YORK. Certainly, an awful lot of our constituents, through no fault of their own—they had a good credit rating, they bought a home. I live on Long Island. A starter home used to be around $500,000. Now, it is about $430,000 but that is still an awful lot of money for a young couple to get together to be able to do that.

So, I thank you again for the FHA loans. But also, I agree with Mr. Gary Miller from California. Unless we somehow come up with getting this housing market going again through the real estate and building, our economy is not going to come back to the way that we want it. And I hope that you are looking at—I know a number of legislators here have given you different ideas, pieces of legislation that we have written to jump-start that, and I hope that we—I was hoping that we could actually do it sooner than later, but this session is almost over.

But the question I want to ask you is, your testimony states that the default rate on FHA loans has been relatively stable throughout this year due to a number of factors, and I know you touched upon it. But can you discuss the overall state of the housing market relative to the stable default rates and anticipated rebuilding of FHA's Mutual Mortgage Insurance Fund for 2012?

Secretary DONOVAN. I think what is critical there is we have seen a substantial decline over about a year, year-and-a-half, leading into this year. We have seen stabilization and even a small increase in delinquency rates in FHA, but also across-the-board. I think that the kind of slowdown that the economy had in the late summer really impacted that to some degree and saw it come up somewhat, but they remained stable and substantially lower than we had seen historically.

And I think most importantly there, the decline of about 45 percent in the number of people falling into foreclosure has been a combination of both lower overall serious delinquency rates as well as the more than 5 million modifications, loan modifications, that I had talked about earlier in my testimony. Those have been key pieces.

Mrs. MCCARTHY OF NEW YORK. My time is short. I know the President had mentioned, and it is something that I had mentioned years ago, that people who go into foreclosures from unemployment or whatever, to try to rent the homes to them until things got better. My time is going to be up, but I hope that you are working on that.

Secretary DONOVAN. We did institute increased forbearance for unemployed homeowners in FHA. We required—we went from a minimum of 4 months to a minimum of 12 months forbearance. We did the same thing with Treasury programs, and we hope that the rest of the market will follow us on that. It is very, very important.

Mrs. MCCARTHY OF NEW YORK. Thank you for your service.

Mr. HUIZENGA. With that, Mr. Canseco from Texas for 5 minutes.

Mr. CANSECO. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for being here today. In your testimony, your written testimony, you mentioned that over the past 3 years, FHA has made homeownership possible for 2.27 million first-time buyers. How many of these first-time homebuyers used the $8,000 homebuying tax credit included as part of the 2009 stimulus bill for their downpayment?

Secretary DONOVAN. Given that the tax credit is claimed after closing, we don't have precise estimates of how many families used the tax credit, so I can't give you a specific answer on that.

Mr. CANSECO. But you mentioned earlier in your testimony that downpayment is a critical piece in the risk analysis; is that correct?

Secretary DONOVAN. Correct.

Mr. CANSECO. Does the FHA categorize using this $8,000 tax credit as a self-funded downpayment loan, which data shows are 3 times as likely to default as other loans?

Secretary DONOVAN. In fact, we were very aware of that history when we established our policy. What we said was we banned any use of the tax credit as a loan or something else that would be go directly towards reducing the downpayment. We allowed the tax credit to be used to increase the amount of downpayment, but we did not allow any homebuyer to monetize that tax credit, to go out and borrow against it or do anything else. The downpayment had to come from their own funds or from family in a way that any other loan would be required. So we made sure to specifically avoid the experience that you are talking about with the tax credit.

Mr. CANSECO. So given that the $8,000 tax credit could have come after the finalization of all of the documents, you can't really follow that $8,000, whether it went to make up for that $8,000 that went into the downpayment?

Secretary DONOVAN. Let us be clear about this. When a family closes, they are required to have a $10,000 downpayment for an FHA loan. We check to make sure that is coming from allowable funds, a bank account they may have, a family member—so we would check. If they go and then get a refund from their taxes at the end of the year of $8,000, all that does is replenish funds, savings that they may have. So it actually puts the homeowner in a better position relative to repaying their loan, not worse.

Our job was to make sure at closing that those funds were coming only from allowable funds, not, for example, by going out to a scam artist or some local lender and saying, well, I am going to get this tax credit; lend me the money to do that. So that was our requirement.

Mr. CANSECO. So your answer is that this tax credit did not go into the seller-funded downpayment assistance?

Secretary DONOVAN. It is a completely different phenomenon. Just to be clear, the risk with the seller-funded downpayment was that you basically had the seller of the home raise the price—we often saw bogus appraisals—and effectively get to zero downpayment or worse. Here the requirement was that they have that downpayment in their own cash, in different family—anything that would be traditionally allowable. So we were very specific about the way that tax credit could be used.

Mr. CANSECO. So FHA estimates that the capital reserve fund could withstand an additional decline in housing prices up to 4 percent and remain positive. Does this mean that the housing price declines in excess of 4 percent will trigger a taxpayer bailout of FHA?

Secretary DONOVAN. To be clear about that, the expectation in the actuary was a 5.6 percent decline this year, and our estimate—and this is only an estimate, there are many other factors—is that everything else staying equal, an additional 4 percent decline next year could trigger the need for additional assistance.

But that is before any changes or other steps we might take. For example, and I lay out five different things we could do in my written testimony, premium increases or a series of other steps that would add capital to the fund and help to avoid that.

Mr. CANSECO. Does the recent increase in loan limits for FHA encourage private capital to get back into the markets?

Secretary DONOVAN. It does not. And that is why we laid out in our White Paper our position, the Administration's position, that the loan limits ought to step down. On the other hand, I do think it is important to point out that they do not, based on early data, put the fund at greater risk.

Mr. HUIZENGA. The gentleman's time has expired.

Mr. CANSECO. Thank you very much.

Mr. HUIZENGA. Mr. Sherman from California for 5 minutes.

Mr. SHERMAN. Thank you.

I do want to reemphasize your last comment, and I know you gave a similar response to Gary Ackerman, and that is this increase does not put the FHA fund at greater risk. If anything, as I understand your data, it should help the FHA absorb some of the risk that it absorbs on loans of less than $625,000.

One concern that people have is, are the FHA reserves adequate? We obviously prefer that they be higher, but it is my understanding that those reserves would not be exhausted if we ended up this year with a 5.6 percent decline in national home prices, and then there was a 4 percent decline next year. Is this right? And do you predict a 4 percent or greater decline in home prices next year? Please tell me no.

Secretary DONOVAN. I will tell you that what our independent data that was used for the actuarial predicted was a 5.6 percent decline. It appears we got third quarter data yesterday from FHFA and Case-Shiller it appears likely that the decline this year will be smaller than that 5.6 percent. It is now year under year just under 4 percent, and their prediction—again, Moody's Analytics prediction—is for a 1.3 percent increase next year in home prices. So I will tell you that is the base case that the actuarial is run off of.

Mr. SHERMAN. So the predictions have been more gloomy than actuality over the last several months, and if the predictions hold, the FHA will not need an infusion of Federal funds?

Secretary DONOVAN. Under the base case, that is correct. I will note, however, that obviously we can't predict the future; that the predictions last year, the performance this year has actually been somewhat worse than was predicted by Moody's last year, and that is why we are evaluating a series of steps that we could take and that we expect to be included in our 2013 budget.

Mr. SHERMAN. You ought to be planning for everything, but the best estimate is home prices will go up infinitesimally next year, and if they even go down by 4 percent, FHA will not need money from this Congress.

One thing I think we tend to agree on here is we want to give consumers as much choice as possible. Another thing I think we all agree on is we want the Federal Government to take as little risk as possible and the private sector to take as much of that risk as possible. And I would like to see Fannie and Freddie's conforming loan limit in high-cost areas raised to $729,000 because then you may, in many of those cases, have private mortgage insurance.

As I understand the current situation, if somebody gets an FHA loan, the Federal Government is on the hook for the first dollars lost. If, instead, that loan was privately mortgage insured and Fannie and Freddie, then the private sector is on the hook for the first losses. Do I have that right?

Secretary DONOVAN. That is correct.

Mr. SHERMAN. And so, if we can give consumers in high-cost areas like Los Angeles a chance to use Fannie and Freddie, that opens additional doors to them, and those doors would involve less of the risk being absorbed by the Federal Government than an FHA-insured loan.

Secretary DONOVAN. I am not sure if you were here earlier. I did talk about the fact that we have never had a situation where FHA loan limits were actually higher.

Mr. SHERMAN. I remember when they were lower.

Secretary DONOVAN. And overall, I would just restate our position that we do think we need over the long term to bring those loan limits down to more historical levels for FHA.

Mr. SHERMAN. While increasing them for Fannie and Freddie, I would hope, because the one way you can get a double-dip recession is to see a decline in values, a precipitous decline in values, of homes in the 10 high-cost areas of the country.

With that, I yield back.

Mr. HUIZENGA. Thank you.

And at this time, the Chair recognizes himself for 5 minutes.

I want to say thank you to a couple of my colleagues who are allowing me to jump ahead here before I have to take off. My background is real estate, as well as a few of the others who are here, and when I was in real estate back in the early 1990s and into the late 1990s, FHA loans were extremely difficult to get, they were very unusual, and were sort of the last resort, because they did go to those who were underserved. And I am glad to hear your position. I hope that it is a clear position you have shared with the Senate, who has pushed this increase on the FHA loan limits, and I encourage you to continue to do that and talk with them as we are trying to readjust this.

I do have one quick question on page 3 of the report that you had given us talking about the underserved borrowers part of that. There is a note that 56 percent of all first-time homebuyers in 2010, according to the National Association of REALTORS®, were FHA buyers. Am I reading and understanding that correctly?

Secretary DONOVAN. That is their estimate, that is correct.

Mr. HUIZENGA. So do you believe that 56 percent of all first-time homebuyers are underserved buyers?

Secretary DONOVAN. What I would say is that we have a dual mission, as far as I understand Congress' creation of FHA, in normal times to serve underserved borrowers, but that in times of crisis, where there is a lack of private capital, for FHA to act as a countercyclical force and to be able to serve a broader group. And I think that is, in fact, what has happened during this crisis, and I think the fact that it is 56 percent of first-time buyers is to some degree a result of that lack of private capital.

So I would certainly expect and, in fact, would hope that number would go down and return to a more normal level, but that certainly is not a level that I believe is the right level over a longer term and in normal times.

Mr. HUIZENGA. I would hope so as well. And the countercyclical element rule for FHA, I think, leads logically to the next question: should all of these first-time homebuyers, these sub-700 credit score buyers—I think that it was noted that 580 was a score that was out there—be in a position to be buying homes?

Secretary DONOVAN. We would be happy to spend some time with you showing the performance data. I think the fundamental question is if they are buying a home they can afford with a product that is going to be safe and sustainable, and they demonstrate that they can be successful homeowners, that is what we are looking at. And certainly, the performance we have seen, the improved performance, tells us that by and large, they can be successful homeowners.

Mr. HUIZENGA. I think that is the fear that a lot of us have in this current economy with the job situation as it is that that may be more risky, which goes back to a number of questions about requirements for reserves and those kinds of things.

And you had—I believe it was Mr. Ackerman who had asked you a question and talked a little bit about bailout for FHA. Your exact quote was, "We don't need one thus far." On page 13, you are making the claim that the current underwriting and premium structures have created an actuarially sound basis for growing capital at a rapid rate in the economy.

I, for one, am pleased that it sounds like it is going to be an easy pledge from all of us on this committee to say there won't be an FHA bailout. I don't know how sure you are of that, but I guess I am looking for some reassurance that the FHA is not going to need that government assistance, because that is what a lot of the concern is that a number of us have on this committee.

Secretary DONOVAN. It is my concern as well, and we have been working very hard to do everything we can to make sure that we protect the taxpayer.

To be clear, the new loans that we are making, even under the most severe economic scenarios that the actuary looked at, would remain profitable. So fundamentally, what we are talking about here is a risk; if the economy and the housing market performed worse than expected in the actuarial, that is the risk that could push FHA's capital reserves into the negative. I can't tell you here today that is a zero risk, because it is not.

Mr. HUIZENGA. But doesn't that sort of go counter to your argument that the FHA is needed for countercyclical, and if you guys are that rock solid, why isn't the private sector stepping in? Some of us suspect it might be some of the regulators that have been clamping down on amounts of loans that banks are holding and those types of things. But I think you are seeing sort of that "push me/pull you" aspect to some of my concern at least.

My time has expired.

Secretary DONOVAN. Briefly, I would say I think we agree that we need to encourage private capital to come back, and the fact that our market share is now shrinking is evidence, I believe, that the steps that we are talking on premiums and on underwriting are, in fact, moving in that direction.

Mr. HUIZENGA. Thank you.

And with that, Ms. Waters of California for 5 minutes.

I believe the chairman had also made a commitment to you because you had missed your opening statement that there would be some additional time, and I will let the next person in the Chair take care of that. So at this point, let us go with 5 minutes, and then ask for additional time.

Ms. WATERS. Thank you very, very much.

I am appreciative for Secretary Donovan and the time that he is putting in on this very, very important issue today.

I would like to remind the committee that we saw this coming last year when the capital reserve level fell to .53 percent. In response, I worked across the aisle with then-Ranking Members Capito and Bachus on the FHA Reform Act, which passed the House on a bipartisan vote of 406–4. Although that bill wasn't signed into law, parts of it, most notably the provisions that allowed FHA to raise the annual and upfront premiums, were enacted separately. These provisions were the most important pieces from my bill because they were designed to give FHA the resources they would need to raise their capital reserve levels. However, the provisions on FHA being able to police fraud were likewise important, and I am disappointed that the Senate didn't take up my bill.

However, Secretary Donovan has taken advantage of the flexibility we were able to get signed into law last year, and FHA has tightened its lending standards. The average FICO score of FHA borrowers has risen from 620 to 700. In addition to more creditworthy borrowers, the recently extended higher loan limits will help FHA to strengthen its reserves.

There has been a lot of speculation in the press about whether or not FHA needs a bailout, and I am certain that you, Secretary Donovan, may have gotten questions to that effect from Members on both sides of the aisle. But I just want to be clear that FHA remains the only source of mortgage credit for most Americans today.

Investors are still reluctant to enter the mortgage market after being burned by originator misrepresentations and fraud during the run-up to the financial crisis, conflict of interest problems continue to plague mortgage servicers, and just last month, one private mortgage insurer filed for bankruptcy.

In the wake of these problems and uncertainty, FHA has taken on a larger market role. That role has helped the middle class. There are millions of working, creditworthy, middle-class borrowers who would not be able to buy a home or to refinance an existing mortgage if not for the availability of FHA mortgage insurance. FHA is singlehandedly holding up our mortgage market. And I must reiterate time and time again that we must support it.

To be clear, I do oppose any attempt to use the current challenges facing FHA as an excuse to dismantle, defund or otherwise destabilize this critical housing program. Now is the time to strengthen FHA, not to weaken it. And I am more than willing to work with my friends on both sides of the aisle to find ways to make FHA stronger, better, and more effective in providing homeownership opportunities to all Americans.

If I may continue, I would like to ask a few questions of the Secretary.

The FHA has made changes to the downpayment requirements for borrowers with FICO scores of 579 and lower, 10 percent downpayment, and prohibits loans for borrowers with FICO scores below 500. Has this change helped contribute to the strong economic value of the current book of business? Is the new premium structure better aligned with market conditions?

Secretary DONOVAN. First of all, Congresswoman, thank you for all your work with us on the FHA bill that you talked about. We do continue to believe that many of those provisions that weren't passed that were part of the bill are critical to allowing us to continue to increase enforcement and other steps. So thank you for your work on that. We look forward to continuing to partner with you on it.

Specifically on your question, the answer is yes, we have seen a roughly two-thirds reduction in early payment defaults in that class of loans, and that really, I think, is a result of the underwriting changes that we talked about.

Ms. WATERS. HUD set underwriting minimums that combine credit score and downpayment requirements to balance risk management, with broad access to housing credit for borrowers who have historically met FHA credit quality standards.

Could you comment on the impact this has had on FHA's current book of business?

Secretary DONOVAN. What we see is between the last 2 years, the actuary predicts about an $18 billion positive net worth for those two books of business, so $18 billion of benefit to the taxpayer from those two books.

I would also say the work that we have done to look at what would happen if we removed the option for lower-risk borrowers to get higher LTV loans, we think we could lose as much as about 10 percent of all the buyers last year. And that is the concern that we have in terms of risk to the housing recovery: If we were to restrict credit too much, it might actually perversely hurt the taxpayer by increasing the losses that we would see on loans that were made in 2008 and before that.

Dr. HAYWORTH [presiding]. May I have unanimous consent for another minute-and-a-half for the ranking member? Without objection, it is so ordered.

Ms. WATERS. Thank you very much.

Mr. Secretary, could you comment on the steps HUD has taken to increase enforcement of FHA lender policies, eliminate approval for loan correspondence, and increase net worth requirements for lenders wanting to underwrite FHA loans?

Secretary DONOVAN. Absolutely. I think one of the first steps that we took was to really create a strong risk management team and culture at FHA, created the first-ever Chief Risk Officer position in the history of FHA. We also increased net worth requirements for lenders that hadn't been increased in quite some time. We stepped up dramatically both the investigations that we were doing, the share of loans that we were reviewing, and consequently we have seen 4 times more lenders removed from the FHA rolls during the period of this Administration than in the entire 8 years of the prior Administration. And we have worked actively with our partners at the Department of Justice to bring cases against the worst offenders and have been successful in a number of those as well.

Ms. WATERS. Thank you very much. I think you have done a great job, and, again, I appreciate all of the attention that we paid to FHA and the way that you perceive it even without all of the legislation that we would have liked to have had passed.

I yield back the balance of my time.

Secretary DONOVAN. Thank you.

Dr. HAYWORTH. The Chair recognizes Mr. Hensarling for 5 minutes.

Mr. HENSARLING. Thank you, Madam Chairwoman.

Mr. Secretary, in the 2011 actuarial study that I guess was released last month, if I read it correctly, we have approximately $1.2 billion in value supporting insurance in force of about $1.9 trillion on the single-family MMIF; is that correct?

Secretary DONOVAN. It is actually not correct, Congressman. There is a total of $33.7 billion in reserves that are held against the book. That is actually the highest level of reserves in the history of FHA. And contrary to what was predicted last year, those total reserves actually—

Mr. HENSARLING. I was talking about just the single-family.

Secretary DONOVAN. This is single-family that I am focused on. I think you are focused on—there are two reserve accounts: the capital reserve account; and the financing account. The financing account is the piece that I believe that you are focused on, and that is only excess reserves that are—I am sorry, the capital reserve account is only excess reserves that are held above and beyond expected losses. So I think, and this is very important, the total cash reserves that we are holding against that book is a total of $33.7 billion.

Mr. HENSARLING. But the insurance in force, $1 trillion; is that correct?

Secretary DONOVAN. It is over $1 trillion, that is correct.

Mr. HENSARLING. Now, in that report I think, if I quote you correctly, "With economic net worth being very close to zero under the base case forecast, the chance that future net losses on the current outstanding portfolio could exceed capital resources is close to 50 percent." I am under the impression that study was based upon June and July data; is that correct?

Secretary DONOVAN. It was based on both predictions for house prices and the latest data as of June, that is correct.

Mr. HENSARLING. And the serious delinquency rate has increased from June to September; is that correct? My data shows that we now have 50,000 more serious delinquent FHA loans in September as compared to June.

Secretary DONOVAN. As the portfolio grows, obviously the number typically increases. As with, I think, all types of loans, there was a slight increase in the serious delinquency rate at the end of the summer.

I would also say, though, home prices have performed better than expected since the June 30th predictions, given that home prices are the single most important factor in predicting the value of the fund; that it is likely that, in fact, the actuarial understates the capital reserves relative to what has happened since June 30th as a result.

Mr. HENSARLING. So, Mr. Secretary, am I to assume you are more optimistic than the statement that was included?

Secretary DONOVAN. Optimism is not something that I think is relevant here, frankly, given the scale of the capital reserves. This is a serious issue. There are serious risks to the fund. We need to take further steps to protect the taxpayer, and we will continue to do that.

Mr. HENSARLING. You obviously have discretion, and I—one, let me say I appreciate the comments that you have made with respect to the conforming loan limits with respect to FHA and what I would view as mission creep. I understand, again, that you have the discretion to increase insurance premiums. I know it has been done once or twice. But I think now the annual premium for a 30-year loan with a 95 percent LTV is 1.15. I think statutorily, if I am correct, you have the authority to increase that to 1.5 and have chosen not to do so given the precarious state of the MMIF. Why have you chosen not to do that?

Secretary DONOVAN. As I said in my testimony, that is something that we are actively looking at. Given that we have just gotten this actuarial review, we are actively evaluating that, and we expect in our 2013 budget proposal to propose additional steps.

But I would say, Congressman, understand that the balance here is we are now charging the highest premiums in the history of FHA, and under any economic scenario, even the most dire, the actuary predicts that new loans that we are making will be profitable. And so while increasing fees for new borrowers is an option, it is also critically important, and we could use the help of the committee in further enhancing our enforcement, to maximize recoveries on old loans. Those are what are really driving the losses, 2008 and prior books of business. And we must balance changes that we make to new loans with focusing on enforcement and recovering on the loans that really are causing the problem.

We can't go back and unmake those loans. Unfortunately, they were made. But we can do as much we possibly can to enforce and recover on those loans, and that is where we need the help of the committee as well.

Mr. HENSARLING. Thank you.

I see my time has expired.

Dr. HAYWORTH. The Chair recognizes Mr. Lynch for 5 minutes.

Mr. LYNCH. Thank you, Madam Chairwoman.

I want to thank the Secretary and Mrs. Galante for your patience and your willingness to help the committee with its work.

The question for me is not whether FHA is needed. Of course, it is needed, and it will be needed for the foreseeable future. The question is whether or not FHA is operating in a way that will be sustainable without a massive taxpayer bailout. That is what I worry about.

I have a very, very good report here that I am going to refer to. It is by the GAO Director of Financial Markets and Community Investment, Matt Scire. He is going to be on the second panel sometime this evening, I expect. But he does a very good job at this. And according to the GAO analysis, there is $4.7 billion in the end-of-year balance in the fund's capital reserve account. You are saying there is $33 billion in that account.

Secretary DONOVAN. Actually, the $33.7 billion is combined between the financing account and the capital reserve account.

Mr. LYNCH. But it is the one that is historically used in this committee and, when your predecessors came up, was always the capital reserve account. It is historic here. And based on earlier testimony by your predecessors, we have always gone by this account. And now you are saying we are combining it with another account?

Secretary DONOVAN. It is two different things, Congressman.

Mr. LYNCH. Because if we could deplete a $33 billion account, and you are not willing to say that we will not deplete a $33.7 billion account, then we have a serious problem, because you are saying that we are not going to go negative on this account. Are you talking about the $33 billion account, or are you talking about the $4.7 billion account?

Secretary DONOVAN. The total cash reserves is what I was talking about. In other words, we are holding against expected losses those reserves. And I was just correcting the—I think I didn't want to leave the impression with the committee that somehow we were only holding $4.7 billion against potential losses.

Mr. LYNCH. So let us talk about the ratio of reserves, the capital reserve ratio. Statutorily, it is supposed to be 2 percent. You are at .24 percent; is that correct?

Secretary DONOVAN. That is correct.

Mr. LYNCH. Okay. Here is the problem. Under the Fed's analysis when they give us the number of homes underwater, the number of homes in arrears, the number of homes in default and in foreclosure, they tell us a very different story than the actuary is telling us, that we are going to remain positive next year. And the actuary told us and this committee in 2008, 2009, and 2010 not to worry, things are going to be okay. And we watched that account go from $22 billion in 2007 to $4.7 billion at the end of 2010.

What I am saying is, I know you are working as hard as you can to do the right thing here, no question about that. We are trying to do the same thing. Congress hates surprises. We hate surprises.

So when someone tells us things are going to be okay next year, and then you report once a year, this actuarial review, and we get terrible news that things aren't all right, as a matter of fact, year after year it is getting worse and worse, that creates a tension between what we are expected to do by our constituents and what is happening here with FHA.

So here is my problem. You are required under the National Housing Act to report this actuarial review, to conduct it and publish it once a year. My problem is that in this market, that is too long a period of time. We are going to get surprised one way or the other. Now, it may be a pleasant surprise, and it may sustain what the actuary is saying, or it may be something that is very negative and we are going to be in a calamitous situation.

What I filed back in 2009 was to ask FHA to conduct their actuarial review every 6 months, semiannual, rather than waiting a full year and we don't have time to react, and we get terrible news and it puts us at a real disadvantage here in Congress.

I can understand when we had $22 billion in that account, we didn't need a review every year. Now we are at .24 percent on that capital reserve ratio. We are at a precipitous point, and it might be the European debt crisis, the sovereign debt crisis there that tips this economy the wrong way, and then we are in trouble.

I am just asking you, would you support an enhanced—the name of my bill was the Enhanced FHA Oversight Act, and what we are looking for is we are looking for this data—

Dr. HAYWORTH. The gentleman's time has expired.

Mr. LYNCH. We are looking for the data twice a year rather than just once a year. Would you support that?

Secretary DONOVAN. Congressman, first of all, let me just say I don't think you have heard me here say today that you don't need to worry that everything is going to be fine. I have said consistently that we need to be vigilant because none of us can predict where home prices are going to go—

Mr. LYNCH. Exactly. So what I am saying is if we get the information every 6 months instead of once a year—

Secretary DONOVAN. Look, it is up to the committee to decide and the Congress to decide what the legal requirements are. What I will tell you is we are running these numbers far more than annually. We are running them on a regular basis—

Mr. LYNCH. Then, there should be no problem with giving us—

Dr. HAYWORTH. The gentleman's time has expired. You can continue your questions in writing, sir. And I thank the Secretary for having remained with us past his hard stop of 12:30.

I am calling on Mr. Stivers. The Chair recognizes Mr. Stivers of Ohio for 5 minutes.

Mr. STIVERS. Thank you, Madam Chairwoman. Mr. Secretary, I am always worried being that my seniority is so low, that by the time I get to question you, we know you have been here a long time. So I appreciate you hanging in with us and I appreciate your candor today.

We are all concerned about the actuarial report. I would like to ask you a couple of structural questions about FHA and then ask some questions about your five recommendations, if that is okay.

First, you referred to your Chief Risk Officer a little while ago, and that is a position that Congress allowed you to fill last year. And my understanding is that position was filled, and then the person has left.

Has that position been filled? Is it filled currently?

Secretary DONOVAN. And I apologize, Congressman, I do need to depart. But actually, our Chief Risk Officer has been promoted to a senior advisor to me directly. We have just brought on another senior advisor for risk. We have 15 positions that we filled in that office this year. So we are strongly working to fill out and complete that risk organization.

Dr. HAYWORTH. And with thanks to the Secretary, Mrs. Galante will remain to answer further questions.

Mr. STIVERS. Mrs. Galante, have you read the GAO report on risk mitigation? One of the things it says is that there is no comprehensive strategy on risk mitigation, and it calls for three specific actions to be taking place. In fact, it also says that the two important parts of the Agency, the single-family housing quality control activities and the Office of Risk Management activities, are still separate as of the date of this report. Has that changed since then?

Mrs. GALANTE. Congressman, I have read the report, and I have commented on the report for the GAO. We generally think the GAO did a very good assessment of the progress that we have been making over the past couple of years integrating the risk office into the overall FHA operations. And so, we are working on a number of the recommendations that they had. Some of them were well in progress by the time the GAO report was done.

Mr. STIVERS. And I would ask you to—I would say that some kind of comprehensive risk-mitigation strategy is really important, and I would ask you to relay to the Secretary who has left, that it is important and that you need to make it a top priority. When you don't have a comprehensive risk-mitigation strategy, you are never—you are going to be playing Whac-A-Mole all the time, and it is just not smart unless you move in that direction.

I do want to talk about some of the five solutions that the Secretary had listed in his testimony. Since last year, you have had the ability to raise loan limits, and you have done it a couple of times, but you have never tiered the rate, so you still have one rate. You don't look at the risk of the customer; you don't have a minimum number rate and look at the risk of a customer and go up further. Do you need further ability from Congress to do that? Because I don't think you do.

And one of the things the Secretary talked about that I really wanted to talk to him about is he talked about the conforming loan limits being higher than he wants them to be. He also has the ability to raise the fees on those mortgages, in particular above the old conforming loan limits in a tiered way, and even though he said those don't raise risk, it makes a lot of sense to raise those limits to encourage the private market.

Is that something that is under consideration? Because I have asked this question before, and it has always been under consideration, and nobody seems to do anything about tiering the fee increases.

Mrs. GALANTE. Again, just to be clear, you are talking about premium increases in our case?

Mr. STIVERS. That is correct.

Mrs. GALANTE. And the answer is all the options—

Mr. STIVERS. I am talking about tiering premium increases. Are you seriously considering it to the point that you would actually do it? Because you have considered it apparently in the past.

Mrs. GALANTE. I will just say we are—all the options are on the table, including some kind of tiering. I think the Secretary alluded to that. Particularly given the higher loan limit that we have, there are some opportunities there, and we are looking at them.

Mr. STIVERS. Please tell us if you need further authority, because obviously you are limited to 1.5 percent. If you need more authority or want the ability to do more, let us know. And that is my final question: Do you require any congressional authority to take any of the five steps that you requested? It looks like you want more authority on lender termination, but I can't tell if that is Congress that grants that to you, because, frankly, I am a freshman, and it is unclear to me, and I am not familiar with everything yet. I am still learning.

Mrs. GALANTE. There are several provisions that were in the FHA reform bill that we would like that additional authority to seek indemnifications from certain types of lenders that we do not have the authority now.

Mr. STIVERS. Can you answer in writing to me about the specific authorities you require from Congress, because it looks like my time has expired. I yield back. Thank you for the time today.

Mrs. GALANTE. Absolutely. I am happy to do that.

Dr. HAYWORTH. The Chair recognizes Mr. Scott of Georgia for 5 minutes.

Mr. SCOTT. Thank you very much.

Just listening to the testimony, and just gathering in what we have heard today, it seems like HUD is—you are sort of caught in a catch-22. You have a situation where, as a result of your falling reserves in your capital fund, you probably will become more vulnerable to defaults. These defaults have to be covered because of the Federal guarantee that we offer to the lenders, they have to be covered, and that is done through the taxpayers. And then, in the final analysis, it means that if your funds are out, then Treasury has to step in. And at the same time, the Secretary has pointed out that the key, the real key, to turning this around and stopping the bleeding and the defaults is home counseling, homeowners counseling, and yet in April, this Congress slashed the money for you to provide the counseling; $88 million, slashed all of it.

So when we look at this, there seems to be a mixed priority here in Congress. Given that, what impact has this slash of the $88 million had? Because I can tell you this from firsthand experience, I agree with the Secretary, the most critical weapon we have to turn all of this around is getting that counseling to the struggling homeowner.

We forget how complex and complicated dealing with this whole issue is for your average homeowner. They refuse to answer the 1–800 number because a lot of them are scared, and when you don't have accurate information and intelligence, you do nothing. And so, when we had our homeowners' event, being able to get the borrowers under one roof with the lenders under one roof, but I found that the key ingredient that helped us more than anything else was having those HUD counselors there. We found out, for example, having FHA there, and you had a HAMP program from Treasury, that if they qualified with the FHA program, then the banks immediately would come together with HAMP because they would support that.

And so my question to you is, you, in September, in your attempt to make up for some of this, put in about $10 million in unspent funds from the previous year to be utilized for this home counseling program. But despite this move, you have expressed concerns over the gap in funding going forward for the 2011 period. So my question then is what level of funding would HUD actually need in order to operate your nonprofit housing counseling program effective for this year coming up, 2012?

Mrs. GALANTE. Thank you for raising the issue of housing counseling. We agree it is a very important one, and we were fortunate with the appropriations bill that just passed that some level of housing counseling dollars in the conference committee was approved for, I think it is $50 million. So we didn't get the $88 million, but we were able to—or we are able to provide for Fiscal Year 2012 some level of counseling dollars to housing counseling agencies. And I am actually really happy you asked that because the notice of funding availability for Fiscal Year 2012 was posted today.

Mr. SCOTT. And so, it is a done deal. We have the money for 2012?

Mrs. GALANTE. We have some money for 2012, yes.

Mr. SCOTT. Is it sufficient?

Mrs. GALANTE. We originally asked for more, and we think we could effectively use more. And I would also say we are doing everything in our power to make sure that the housing counseling program, not just for the grantees, but for the administration of it, is as effective as it can be, and so we certainly could use additional funds for that program if they were available.

Mr. SCOTT. And some HUD-approved housing counseling agencies have been inundated with new clients with every new Federal program. Wouldn't it be beneficial if HUD could contract directly with these housing counseling agencies in assisting delinquent homeowners with qualifying mortgage workout solutions?

Mrs. GALANTE. A number of these housing counseling agencies are directly helping borrowers get through their processes with servicers. They are very effective in helping people through the loan modification process.

Dr. HAYWORTH. The gentleman's time has expired.

Oh, Mrs. Galante, I am sorry, do you want to finish that answer?

Mrs. GALANTE. I think I finished.

Dr. HAYWORTH. I thought so, too.

The Chair recognizes Mrs. Biggert of Illinois for 5 minutes.

Mrs. BIGGERT. Thank you, Madam Chairwoman.

And, Mrs. Galante, it is nice to see you here.

Can you talk a little bit about the QM and the QRM rules? As they are being currently promulgated by the regulators, do they have the potential to drive more business to the FHA at the exclusion of the private market, or will it—might the private market be able to increase in this area?

Mrs. GALANTE. I think, as we have discussed on some prior occasions, the QRM rules still in process, multiple Federal agencies looking at what it will be. One of the aspects that was in the proposed QRM rule was higher retention levels for loans with higher downpayments, and there is a concern that will drive more business to the FHA.

Obviously, we don't know what the rule is going to be, so we don't know what the ultimate impact will be. But we are concerned and are monitoring that as we are part of the discussions on QRM.

Mrs. BIGGERT. Would there be anything that would be put in there that could ensure that the private market will have access, or is it just because of the way that they are drawn?

Mrs. GALANTE. Again, I am not close enough to all of the negotiations on the QRM negotiations on what is ultimately going to come out, so I think it is difficult for me to answer that.

Mrs. BIGGERT. And then, FHA has estimated that the capital reserve fund could withstand an additional decline in house prices, and talk about 4 percent beyond the baseline decline, without experiencing a negative capital situation. Does that mean that a decline in excess of 4 percent would result perhaps in a taxpayer-funded bailout of FHA? Would you need more money?

Mrs. GALANTE. I appreciate that question, and the answer is this: Without any other kinds of policy changes, with no premium increases, if house prices again got to a much worse point than they are today, or than we project they will be today, then there will be—there is a possibility that we would need some additional support. But we are doing everything in our—and that is part of this five-point plan we are talking about. We are going to do everything in our power to look at actions that we can take to ensure that we avoid that situation.

Mrs. BIGGERT. Thank you.

And I think most of my other questions have already been asked, so I will yield back.

Dr. HAYWORTH. The chairman recognizes Mr. Green from Texas for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman.

I thank the witness for staying with us, and I would like to explore a line of questioning that will help us better understand what FHA has done and continues to do with the economy.

Let us start with loan originations. These FHA loans, tell us quickly, please, where—meaning in what facility—are most of them originated? Would that be a bank?

Mrs. GALANTE. Yes. So, again, FHA is insurance, and private lenders are actually the ones that are originating the FHA loans.

Mr. GREEN. Now, most of them today are originated with banks; is this correct?

Mrs. GALANTE. Yes. There are financial institutions; banks are certainly part of it.

Mr. GREEN. So banks benefit from it. Banks don't do this for free, they do it for a fee, true?

Mrs. GALANTE. Certainly. Yes.

Mr. GREEN. A loan-origination fee?

Mrs. GALANTE. Certainly, yes.

Mr. GREEN. And banks then hire people who do this type of work?

Mrs. GALANTE. Correct.

Mr. GREEN. My point is that there is a broader impact on the economy than just the person buying the home. The banks benefit; REALTORS® benefit because REALTORS® help persons buy homes. They assist with the homebuying process. Purveyors of products, they benefit when a home is built. And, by the way, builders benefit because they will build more homes if homes are selling. The purveyors of products, washing machines, and dryers, and stoves and carpet, all of these things go into homes, they benefit. The benefits go far beyond the simple purchase of the home. That is—and actually not the genesis of the process, because the builder constructed the home understanding that there was a market for it to be sold in. And then, of course, we have the manufacturers of products that benefit.

So at a time when we need this countercyclical force, FHA is serving a meaningful, needed purpose. It not only helps us with selling the home, but the home becomes so important to other industries associated with the homebuying process and with the construction of the home.

FHA is, in my opinion, an entity that, if it did not exist, we would probably try to create it or something similar to it, because it did not come into existence on a whim. There were some severe problems that we were contending with in the 1930s, and FHA was produced and gave us this exotic product known as a 30-year loan. I think we can attribute that to FHA, because at the time a 30-year loan was anathema, it was not commonplace; it is something that we have now. And we think little of the notion of getting one, but at one time it was very difficult to get a 30-year loan, if not impossible, because you had big balloons, and you had to refinance, and people of little means or modest means, middle-income Americans, they didn't get homes to the extent that they do today. So FHA serves a meaningful purpose.

Do you have empirical evidence to support the actual impact that you have had in the area of homes being sold by REALTORS®, the impact on builders, the impact on manufacturing, the impact that goes beyond the simple purchase of the home, which is important; but do you have empirical data that deals with those other industries and how they are impacted?

Mrs. GALANTE. That data certainly exists. I don't have the multiplier effect specifically in front of me, but absolutely there is no doubt that what you described is the case, and many of the data support that. I know for new construction, for example, you could essentially assume long term, a certain number of jobs per house built.

So there is no doubt that there are many, many industries involved in providing jobs and economic benefit to communities as part of not just homeownership or new home purchase, but also just as a matter of refinancing. You can put additional money in people's pockets if you refinance at today's low interest rates, for example. And that also puts more money in people's pockets to spend on needed goods and services.

Mr. GREEN. With my last 5 seconds, let me just say quickly that this service that is rendered has helped to keep unemployment that is high from being even higher, because if we didn't have you with this 56 percent of first-time homebuyers—

Dr. HAYWORTH. The gentleman's time has expired.

Mr. GREEN. Thank you, Madam Chairwoman. I am grateful. Thank you.

Dr. HAYWORTH. The Chair recognizes Mr. Cleaver for 5 minutes.

Mr. CLEAVER. Thank you, Madam Chairwoman.

Mrs. Galante, I am in and out, and I actually hope somebody already raised this issue, because I think it is extremely pertinent to this conversation.

One of the former Chairs of this committee, Henry Gonzalez helped create the Cranston-Gonzalez National Affordable Housing Act. And they created this, the 2 percent capital reserve ratio, and it was designed to strengthen the firm.

One of the things that has not been discussed here today, a lot has been said about the capital ratio being below 2 percent, and so one of my pains is that many of my colleagues, perhaps on both sides, are not aware of the fact that there is a separate cash fund, and it was put in place to address the unexpected losses in the MMI Fund. I think that is maybe $33 billion?

Mrs. GALANTE. That is correct.

Mr. CLEAVER. If everything I am saying is close to correct—even correct it further if it needs correction—but what I am interested in is that fund is growing, and if that is true, then maybe this committee could benefit from having a contextual discussion from you about this, because I see them as inextricably connected, and we have not connected it in this discussion today.

Mrs. GALANTE. Yes. So again—

Mr. CLEAVER. And correct me gently.

Mrs. GALANTE. This is complicated, and it is easy for people to mix things up in this case, but I just want to say again, total capital resources available to FHA today is the $33.7 billion, which consists of a financing account which is where we pay our claims out of, where we, so to speak, transfer funds into to actually pay expected claims.

The capital reserve account is the additional account, but it is part of that $33.7 billion, but it is a piece that is specifically supposed to be for unexpected claims above and beyond the expected ones that we transfer into the financing account.

So that is the total capital resources available to FHA today.

And the capital reserve ratio is actually based on yet another calculation of the total insurance in force and the expected economic value, so of that—of the book of business and the—minus the potential claims over time. So it is kind of two different calculations that you have to keep in mind.

Mr. CLEAVER. But we have more funds there today than we had last year at this time.

Mrs. GALANTE. That is correct.

Mr. CLEAVER. That is so relevant to the discussion. I find it painful that my colleagues were not able to get that information out.

I actually have no other questions, but it would be my hope that somehow we are able to get some kind of discussion or some information to Members about Gonzalez-Cranston, or is it Cranston-Gonzalez?

Mrs. GALANTE. Cranston-Gonzalez.

Mr. CLEAVER. I apologize to Mr. Cranston, but I do think it is relevant, and we need to get some information out. Is there any—do you have any ideas on how we can get members of this committee aware?

Mrs. GALANTE. Again, we are happy to continue to have conversations, have individual meetings, have dialogues, and work sessions. We do produce the annual report to Congress. We also produce quarterly reports that are delivered that go into some pretty good detail.

Mr. CLEAVER. Do you think Members are reading those?

Never mind. I was speaking out of turn.

Dr. HAYWORTH. The gentleman's time has expired.

The Chair would like to thank Mrs. Galante for remaining with us, and with that, the Chair notes that some Members may have additional questions for the panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

Mrs. BIGGERT [presiding] The Chair now calls the second panel.

I would like to welcome the second panel and thank you for your patience. I don't think we expected that to go quite that long. But we will start right away. And I would like to introduce the panel: Mr. Matthew Scire, Director of Financial Markets and Community Investment, U.S. Government Accountability Office; Dr. Andrew Caplin, professor of economics, Department of Economics, New York University; Mr. Henry Cunningham, Jr., CMB, president and CEO of Cunningham and Company, on behalf of the Mortgage Bankers Association; Mr. Patrick Sinks, president and chief operating officer of the Mortgage Guaranty Insurance Corporation, on behalf of the Mortgage Insurance Companies of America; Mr. Moe Veissi, 2012 president, National Association of REALTORS®; and Ms. Sarah Rosen Wartell, executive vice president, Center for American Progress Action Fund.

And thank you all for being here. Without objection, your written statements will be made a part of the record, and you will be recognized for a 5-minute summary of your testimony. We will start with Mr. Scire. You are recognized for 5 minutes.

STATEMENT OF MATTHEW J. SCIRE, DIRECTOR OF FINANCIAL MARKETS AND COMMUNITY INVESTMENT, U.S. GOVERNMENT ACCOUNTABILITY OFFICE

Mr. SCIRE. Thank you. Madam Chairwoman, and 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. Recently HUD released the results of its latest independent actuarial review finding that the capital ratio used to measure the financial soundness of the fund had declined to 0.24 percent, well below the statutory minimum of 2 percent. This is the third consecutive year that HUD reported not meeting the minimum capital ratio.

Let me start by describing the reasons for the capital ratio's steep decline since its peak in 2006. Put simply, the ratio declined because the economic value of the fund dropped sharply at the same time that the insurance-in-force grew. This rapid growth in the amount of all loans FHA insures was due to the growing demand for FHA mortgage insurance. By the end of 2011, FHA had outstanding insurance that was almost 4 times the level it had at the end of 2006.

We previously reported that the sharp decline in the fund's economic value was due to several factors, including more pessimistic forecasts for house prices which would result in higher claims and more pessimistic assumptions about losses. HUD attributes last year's drop-off in its estimate of the fund's economic value to further declines in home prices which resulted in higher than expected defaults, claims, and losses on claims. Also, HUD points to changes in the model itself. These include accounting for loans that had previously been seriously delinquent and assuming that loans likely affected by delays in the foreclosure process would result in claims in 2012. From a budgetary perspective, the worsening expectations for loan performance ultimately resulted in HUD recognizing a $10 billion increase in the reestimated cost of the program for 2009 and a similar amount for 2010.

The capital reserve account has also seen declines in recent years. If this account, which now stands at $4.7 billion, were to be depleted, FHA would require additional Federal funds to cover its costs on outstanding insurance.

Last month, we reported a number of challenges that FHA faces given its rapid growth. To its credit, FHA has taken some important steps. It raised premiums, tightened underwriting, raised requirements of its lenders, and put in place more risk-based approaches to manage its growing workload. Also, with approval of Congress, FHA created the Office of Risk Management and Regulatory Affairs to bring focus to risk assessment and management.

However, the efforts of this office have been limited by staff resources and leadership turnover, and its efforts to assess risk and similar efforts by the Office of Single Family Housing have not been integrated. Here we think there is more that FHA can do to put in place an integrated and timely process for assessing and managing risks, particularly risks linked to its rapid growth. Further, the Office of Single Family Housing continues to face human capital challenges but has not done all it could to identify and put in place the skills and resources that it needs. Also, it can do more to plan for likely turnover in staff, a pressing challenge given that half of its headquarters staff and nearly two-thirds of its field staff are eligible to retire in the next 3 years.

Returning to FHA's fund, we continue to believe that FHA can do more to measure its financial condition. In particular, past reviews have relied on a single economic forecast to determine compliance with a 2 percent capital ratio 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. Last year, we recommended 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 value.

Twenty years ago when the 2 percent capital ratio was first mandated, the Congress required that FHA reach the 2 percent threshold in 10 years. Today, it may be appropriate for the Congress to specify the time period by which it expects FHA to return the capital ratio to 2 percent, taking into account FHA's statutory operational goals and role in supporting the mortgage market.

GAO is committed to providing Congress with effective oversight of the FHA program, including its efforts to rebuild the fund's capital ratio. We look forward to supporting this committee's efforts.

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

[The prepared statement of Mr. Scire can be found on page 105 of the appendix.]

Mrs. BIGGERT. Thank you so much. Dr. Caplin, you are recognized for 5 minutes.

STATEMENT OF ANDREW CAPLIN, SILVER PROFESSOR AND PROFESSOR OF ECONOMICS, DEPARTMENT OF ECONOMICS, NEW YORK UNIVERSITY

Mr. CAPLIN. I would like to thank you all for permitting me to testify regarding FHA's Mutual Mortgage Insurance Fund. My message is somber and is intended as a call to arms. The situation is serious and the risks great. These risks are not being properly accounted for in the actuarial report. There is a far higher probability than currently projected that a large bill will be due taxpayers, that FHA-backed home buyers will face foreclosure, and that Congress will be called upon to significantly recapitalize FHA's insurance fund. History will judge us poorly if we bury our heads in the sand. Time is most definitely not on our side.

There are two crucial steps FHA can take to better account for the risks it faces and thereby safeguard its Mutual Mortgage Insurance Fund. The first is to fill a profound gap in the actuarial review. This makes it impossible currently to answer basic questions such as: one, what proportion of recent FHA-backed borrowers has already defaulted; two, how many such borrowers remain at serious risk of default; and three, how many of those who are still at risk are likely to ultimately default?

The centrality of these questions is evident. The answers determine the risks that FHA programs pose to taxpayers and their role as guarantors. They determine the probability that FHA-backed homebuyers will face the trauma of foreclosure. They determine the probability the Congress will be asked to recapitalize FHA's insurance fund. They determine the likely timing and size of any such request or requests.

The fact is that the actuarial report does not answer these questions. Rather than projecting the success and failure of FHA-backed borrowers, it projects the performance of FHA-backed mortgages. This results in downward biased loss projections. Work initiated some 2 years ago with Joe Tracy, Executive Vice President and Senior Advisor to the President of the Federal Reserve Bank of New York, suggests this bias may be highly significant.

While it sounds like a narrow technical issue, the distinction between projecting borrower performance and projecting mortgage performance is of highest practical significance. In recent years, the FHA's streamlined refinance program has been in high demand. In this program, FHA-backed mortgages can be refinanced to prevailing lower rates without any new underwriting. I regard this as an excellent program. The problem is not with the program but rather with the actuarial report which treats each such refinance as if it extinguished FHA's insurance obligation. In truth, there is no cancellation of the underlying insurance and little in the way of additional fees to FHA. By lumping refinancing together with prepayments in which FHA's insurance obligation is extinguished—for example, following a successful home sale—the actuarial report overestimates FHA's past and future success rates.

My ongoing work with Joe Tracy suggests that the resulting underestimation of losses is significant. In this period of falling rates and housing market trauma, streamlined refinancing appears to have been the most prevalent method of repayment. How could it be otherwise? There has been a significant incentive to refinance as rates on standard FHA-backed mortgages have tumbled. In the meantime, there has been little opportunity for successfully selling recently purchased homes and moving. If our preliminary findings on mortgage payment determinations hold up to further work, as we expect they will, default rates on recent FHA mortgages will stay at elevated levels for years after they are currently projected to decline.

Joe's and my slow progress on our research results from difficulties in gaining access to FHA data. This has forced us to seek and ultimately to find alternative data sources. FHA would have been far better served had we been able to contribute to their work on risk assessment and risk mitigation. Yet, IFE alone has access to FHA data. I propose that HUD instruct IFE immediately to reestimate the loss model linking together FHA mortgages that are refinanced one into another. By itself, asking for the model to be rerun is not enough. The current monopoly not only produces low transparency but also reduces our understanding of FHA risks. To allow this to continue is to invite tragedy.

I propose, therefore, that Congress supply HUD with the additional resources it requires to make data available to outside researchers, including the Federal Reserve Bank of New York. Risk assessment will be dramatically enhanced once additional teams are encouraged to participate. The resulting improvements will help FHA retain its reputation for helping homebuyers while safeguarding taxpayers.

The eyes of history are on us. It is time to act.

[The prepared statement of Dr. Caplin can be found on page 72 of the appendix.]

Mrs. BIGGERT. Thank you so much. Mr. Cunningham, you are recognized for 5 minutes.

STATEMENT OF HENRY V. CUNNINGHAM, JR., CMB, PRESIDENT AND CEO, CUNNINGHAM AND COMPANY, ON BEHALF OF THE MORTGAGE BANKERS ASSOCIATION (MBA)

Mr. CUNNINGHAM. Thank you, Madam Chairwoman, and members of the committee.

FHA is at an important crossroads today. Since the onset of the financial crisis, FHA has played an important countercyclical role in our Nation's mortgage market. Considered irrelevant just a few short years ago, the agency is now providing much needed liquidity during a period marked by the prolonged retreat of private capital. I think it is fair to say the housing recovery, although very fragile, would not have taken place without FHA. However, FHA single-family programs haven't been immune to the historic disruptions that have roiled our markets and that is why we are here today. The actuarial report is sobering and calls for a fresh look at FHA's fiscal health and the role it plays in our housing finance system.

First, I want to take a few minutes to examine the steps this committee and FHA put in place that have allowed the agency to better manage its risk exposure. In 2008, Congress passed the Housing and Economic Recovery Act. That legislation terminated the failed seller-funded downpayment assistance programs that were responsible for the disproportionate level of FHA's defaults. It also permitted FHA to raise premiums, a tool FHA has used twice in the last 2 years. During that period, FHA has taken other important administrative actions designed to protect its financial stability.

These include the following: increasing downpayment requirements from 3.5 percent to 10 percent for less creditworthy borrowers; eliminating FHA's approval of loan correspondence; raising lender net worth requirements; re-examining reverse mortgage policies; and finally, establishing the Office of Risk Management. MBA recommended these steps and commends HUD and FHA for taking these necessary measures in order to reduce taxpayer exposure and strengthen FHA for the long term.

These measures are working. They are allowing FHA to weather the economic downturn and are putting it on track to raise its capital reserves above the 2 percent level mandated by the statute. The change in premiums alone has been largely credited by the actuaries for raising FHA's total cash plus investments by $7.7 billion.

While these steps have proven successful, FHA is not out of the woods. The actuarial report found nearly a 50 percent chance that FHA's capital ratios could slip below zero, potentially requiring a capital infusion from the Treasury. Another recession or a drop in home prices could be a tipping point that causes greater losses for FHA.

So what can we do to help FHA emerge healthy? We can start by getting the Qualified Residential Mortgage rule right. As it is currently proposed, the rule would require a 20 percent downpayment to obtain the QRM while FHA requires just a 3.5 percent downpayment. The QRM definition appears to conflict directly with the efforts by Congress and the Administration to reform the housing finance system. It would make it more difficult for private capital to re-enter the housing finance market, and it would lead to overutilization of FHA's programs.

Another key component of putting private capital on the front lines is to revitalize a secondary mortgage market. MBA has put forward a suggested framework for a limited but clearly defined government role in the single family and multi-family mortgage markets.

Our recommendations carefully balance the government's ability to ensure liquidity with the need to protect taxpayers from the credit and interest rate risk associated with mortgage finance. It is a plan that promotes the return of private capital while limiting the government's footprint in mortgage finance, helping the market function efficiently while protecting taxpayers.

Madam Chairwoman, MBA believes the tools FHA has put in place, the strong leadership at HUD, and continued congressional focus on issues like the QRM in housing finance reform will help FHA emerge from this downturn and allow it to continue playing its important role in the mortgage markets.

Thank you for the opportunity to testify today.

[The prepared statement of Mr. Cunningham can be found on page 75 of the appendix.]

Mrs. BIGGERT. Thank you so much.

Mr. Sinks, you are recognized for 5 minutes.

STATEMENT OF PATRICK SINKS, PRESIDENT AND CHIEF OPERATING OFFICER, MORTGAGE GUARANTY INSURANCE CORPORATION, ON BEHALF OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA (MICA)

Mr. SINKS. Thank you, Madam Chairwoman. I am pleased to be here representing the Mortgage Insurance Companies of America to discuss FHA's actuarial soundness. Since private mortgage insurance and FHA operate in similar markets historically, MICA has offered the industry's insight into FHA's financial condition and suggested ways to improve its operation.

MICA was one of the few members of the housing sector which advocated for the 1990 reforms to FHA that mandated a 2 percent capital ratio in the actuarial report that is the subject of today's hearings.

I would like to make two basic points: first, FHA is on the brink of becoming a subsidized program and steps must be taken immediately to put it on track to financial soundness; and second, while FHA and private MI serve similar markets, the historic balance between the government and the private sector has been destabilized in recent years. The balance should be restored to bolster the FHA and allow private capital to serve the market to its full capacity. Returning the FHA to actuarial soundness and returning the FHA and the private sector to their historical norms are not mutually exclusive goals and in fact can be achieved in tandem.

We believe the committee should focus on two significant points made by the actuarial study. They are as follows: First, although press reports have focused on the fact that the capital ratio of the entire Mutual Mortgage Insurance Fund is at 0.24 percent, the capital ratio for the traditional single family program is half that, 0.12 percent. This is a ratio of 846 to 1. A small, much smaller reverse mortgage program is boosting the overall capital ratio of the FHA to the 0.24 percent.

Second, according to the HUD report to Congress, within just a single-family program, there is only $1.2 billion of economic net worth supporting just over $1 trillion of insurance-in-force. This should be of concern since the FHA insures 100 percent of each loan so its potential loss exposure is the full $1 trillion.

There are three reforms to FHA that would help return it to actuarial soundness. They are as follows: First, FHA must build capital and therefore it should raise its premium immediately. It can be done without new legislation. FHA should raise the annual premium to the maximum allowed under current law. Further, to ensure that the FHA provides a greater cushion for the taxpayer, it should be required to keep premiums at this higher level until the capital ratio returns to 2 percent and for several years thereafter.

Second, by statute, FHA's minimum downpayment is 3.5 percent, while private MIs are generally at 5 percent. In view of the market realities today of falling and stagnant home prices, FHA's minimum downpayment requirements should be increased to 5 percent.

Third, the way FHA's loan limits are calculated skews them so they are as high as possible, exposing the FHA to greater loss. Two specific changes need to be implemented in this regard: One, since currently FHA uses house price data going back to 2008 rather than the most currently available data to get the area limit, FHA should use the most currently available house price data in setting its limits so that they are realistic given the change in house prices over time.

Two, current law requires that the FHA limit for a county in an MSA is set at the median house price for the highest priced county within the entire MSA. The law should be changed so that FHA is no longer required to target its limits to the highest priced county within an MSA.

Finally, part of the answer to ensuring the long-term viability of the FHA and providing protection to the taxpayer is to restore the balance of the FHA in the private sector to its historical norms. This has been a goal expressed by Secretary Donovan. One means of accomplishing this is to eliminate the fees charged by the GSEs on top of the MI premium. As noted in the HUD report to Congress, these fees made privately insured loans more expensive than comparable FHA loans. If the GSEs believe that they need more credit risk protection, they can require deeper MI coverage. This would be less expensive to the borrower and safer for the taxpayers. In fact, since the crisis began, the private MIs have paid $28 billion in claims and receivables to the GSEs, reducing taxpayer loss by 15 percent. In addition to restoring this balance, the FHA and the private MIs should work more closely together complementing each other's strengths to ensure that the low downpayment market is served in an efficient and consistent manner.

In conclusion, we believe that, like in 1990, FHA is at a crossroads and there are actionable steps Congress can take to put FHA on the road to actuarial soundness, allow the private sector to take a greater role, and further protect the taxpayer.

Thank you very much. I will be happy to answer any questions.

[The prepared statement of Mr. Sinks can be found on page 125 of the appendix.]

Mrs. BIGGERT. Thank you, Mr. Sinks. Mr. Veissi, you are recognized for 5 minutes.

STATEMENT OF MAURICE "MOE" VEISSI, 2012 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS® (NAR)

Mr. VEISSI. Thank you, Madam Chairwoman, and members of the committee. Thank you for the opportunity to offer our views on the importance of the Federal housing mortgage insurance program. My name is Moe Veissi. I am the 2012 president of the National Association of REALTORS®. But more importantly, I am a practicing real estate professional with more than 40 years experience as a REALTOR® and broker-owner of Veissi Associates in Miami, Florida.

The 1.1 million members of the National Association of REALTORS® represent a broad array of housing and industry professionals who are committed to making the American Dream possible. In front of you is the written text. And I wanted to chat with you for my balance of the 5 minutes about FHA and how important it is to the housing community of America, not just from the financial and economic standpoint that we talk about but, more importantly, independently how it knits the fabric of the American community together.

We have found and have evidence that folks who own a home live in their home longer, their marriages stay together longer, their kids get better educated, and they go on to profit from better jobs. There is significantly less time spent in front of the TV. There is less teen pregnancy. I can go on and on and on. Homeownership in America knits the fabric of America together. Anytime you do anything to diminish homeownership in America, you diminish the moral character and the promise of America to Americans today.

Some of the things that weren't talked about but questions asked, were, what happens when a home is sold? Let me tell you what happens when a home is sold in America. Number one, $60,000 of additional money is spent in the first 18 months from the time that home is closed. That is new roofs, landscaping, painting, furniture, carpeting. And every time two homes are sold, one brand-new job is created. So in America, with our prospects of about 4.5 million sales this year, we will generate over 2.2 million jobs.

When FHA was first promulgated in 1934, it wasn't a matter of doing something specifically for the mortgage market or even insuring mortgages. What it was thought of to be was an institution available to provide money for homeowners who didn't have the money to repair homes during the Great Depression and afterwards. But what it really was thought to be was a job creation bill. And that was because they figured on that time, what we are going to do is we are going to create a few bucks for the folks who didn't have the money to repair their homes. Now we will. And that is exactly how it came about.

You diminish America's opportunity in any capacity, especially today when we are just beginning to remove ourselves from one of the most horrendous housing situations that the country has ever seen, and you do that at peril to destabilize the recovery of the American housing market. We anticipate that probably in 2012, we will see an appreciation rate of about 1.2 percent. After that, we will see a better appreciation rate. That comes from our economists at the National Association of REALTORS®.

We also anticipate, frankly, that some of the areas in the country that were overbuilt—one of which was Miami with a tremendous amount of vertical development—may, according to our chief economist, see in 2012 one of the few places in America that will appreciate in double-digit figures for that year. And we have seen things in my travels across the country, the Phoenix-Scottsdale area and to the Las Vegas area, that REALTORS® there are beginning to tell us, the market is moving. It is not just the light at the end of the tunnel. It really is a diminishment of the existing inventory that exists today. And that is a great indicator. Do something to create a problem with that, diminish that, kill that, worry—not just the industry but the consumer and the prospects of America today to buy and create homeownership, and I think you diminish the economic prospect of America itself. Of the last eight recessions, six—six fully have come out because you have a robust and a very rounded and energetic real estate economy.

In conclusion, NAR believes in the importance of the FHA mortgage and insurance program and believes that FHA shows tremendous leadership, strength, and vitality during this crisis. We wholeheartedly support the FHA program and we stand ready to work with Congress to enhance FHA's mission, service, and purpose.

Thanks for the opportunity.

[The prepared statement of Mr. Veissi can be found on page 138 of the appendix.]

Mrs. BIGGERT. Thanks so much. Ms. Rosen, you are recognized for 5 minutes.

STATEMENT OF SARAH ROSEN WARTELL, EXECUTIVE VICE PRESIDENT, CENTER FOR AMERICAN PROGRESS ACTION FUND

Ms. ROSEN WARTELL. Thank you, Madam Chairwoman. Let me start by reflecting that it is actually remarkable that FHA has not yet required any supplemental support given that yet so many other mortgage invested institutions have needed help. FHA has so far weathered the worst housing collapse arguably in history while serving primarily low- and moderate-income borrowers and playing a key countercyclical role that has prevented a more devastating overcorrection in the housing market. Without FHA, one could estimate at least a million homeowners might not have had access to mortgage credit in the wake of the crisis, which would have further chilled housing demand, depressed prices, and exacerbated the downturn.

FHA's ability to play this role is a function of its government insurance model where stronger books of business help cover losses from weaker periods. FHA faces significant losses ahead from loans that it insured in the years immediately prior to the financial crisis, especially a large number of loans with seller finance assistance. But its more recently insured loans are projected to have significant economic value.

The capital reserves of the MMI fund, beyond the expected losses, are nonetheless uncomfortably low. More than anything else, FHA's solvency depends upon whether and the extent to which housing prices continue to fall in the next 2 years. As we have heard the actuaries say, absent further adjustments FHA's capital reserves can likely withstand a further drop in house prices over the next 2 years, larger than most forecasts. But even if house prices continue to fall and the cushion is insufficient, FHA still has tools to bolster its reserves by further adjusting premiums or tightening underwriting.

I would argue that FHA should focus on premiums and should consider charging higher premiums on higher value loans in its unusually large market at the current time.

Low interest rates leave room for borrowers to absorb slightly higher fees without creating an affordability barrier to access. In contrast, higher underwriting standards, especially higher downpayment requirements on top of the currently already tightened standards, could make it difficult for a broader swath of homeowners to obtain mortgages, putting further downward pressure on housing demand, continued weakness in house prices and potentially creating further risk to the MMI fund.

Other longer-term policies could also strengthen FHA. Congress should consider structural reforms such as that proposed by the bipartisan Millennial Housing Commission in 2002 to make FHA a more nimble but disciplined government corporation with independent oversight of its performance and serving underserved markets and meeting financial targets but with greater flexibility in product, design, and personnel to meet those needs. Risk sharing is another way that FHA could limit its risk exposure while improving its operations. Full insurance coverage is necessary at times to attract capital during downturns for untested products and to serve underserved markets. But the government may be able to reduce its risk and expand its markets by taking advantage of a risk partner's assessment and mitigation capabilities.

Finally, let me note that FHA's role in the housing finance system of the future very much depends on how policymakers act on other policy issues, particularly how they wind down the Government-Sponsored Enterprises and build a new housing finance system in their place. If you strip all government backstop from the conforming market, FHA will likely be forced to maintain or even grow its current inflated market share and sustain its first loss risk. If the government maintains an explicit guarantee on select types of conforming mortgages, standing behind private capital and charges for it so that it can hold actuarially sound reserves against its guarantee, FHA would be able to return to a more manageable share of the market when prices stabilize.

I also share the concerns expressed by Mr. Cunningham that the current QRM proposal could unnecessarily drive business and risk to FHA that could well be served by the private sector.

In closing, I note that if the recent crisis taught us anything, it is the imperative to closely monitor the business practices and the actuarial health of our essential financial institutions, as this committee has appropriately chosen to do today. Congress and FHA officials together have the tools available to ensure that FHA continues to play its essential role while protecting the taxpayers.

Thank you.

[The prepared statement of Ms. Rosen Wartell can be found on page 147 of the appendix.]

Mrs. BIGGERT. Thank you so much. You all must be well-seasoned witnesses because you have all held right to the 5 minutes, and we really appreciate it this afternoon.

I ask unanimous consent to enter into the record written testimony from Brian Chappelle of Potomac Partners LLC. Without objection, it is so ordered.

We will now turn to questions from the Members. We will adhere to the 5 minutes. And I will recognize myself for 5 minutes.

Mr. Caplin, you have concerns that FHA is understating their losses. Can you explain your concerns and to what extent FHA is understating their losses?

Mr. CAPLIN. Yes, I am very concerned that they are understating it. It is to do with something that looks technical but is incredibly important today. The technical point is that they are measuring losses on mortgages. So when you hear about the 2009 book of business, that means the mortgages that have been refinanced into 2009. That does not mean the people who first bought a home in 2009. So when you hear that there is a much better book of business in 2009, that mixes together people who are purchasing new in 2009 and those who have refinanced into 2009. It is not surprising that those who couldn't refinance are doing worse because there is a qualification criteria in order to refinance, which is that you have to be current.

The big deal is that many terminations of mortgages that, in fact, do not cause cancelation of the FHA mortgage obligation are treated exactly the same as if they gave rise to a cancellation of that obligation. That means that there is an absolutely incorrect assessment of the risk of future default. It is simply flat out wrong. It is understated because every time anybody streamlined refinances, they get counted as a mortgage termination that ends FHA's insurance obligation. It does not.

Mrs. BIGGERT. Thank you so much for that. I appreciate it.

Mr. Cunningham, do you think that the QRM definition adheres to the Administration's GSE White Paper?

Mr. CUNNINGHAM. I think that the QRM, as proposed, requires— I don't think the White Paper anticipated or didn't indicate any particular downpayment requirements. So I think that the White Paper didn't anticipate that. I think the rule, as proposed, has gone beyond that.

Mrs. BIGGERT. So it really just popped up after the White Paper came out?

Mr. CUNNINGHAM. It was after the White Paper came out. The regulators collectively proposed the rule that you see before you today.

Mrs. BIGGERT. Is the Mortgage Bankers Association concerned about the QRM?

Mr. CUNNINGHAM. We are concerned about the QRM and are equally concerned about the QM. We think that both of those should be considered together. We actually think that the QM is a better starting place. The concept of a borrower qualifying for a mortgage is certainly a way to promote sustainable homeownership. So I think that it is important to have a bright line test for qualifying a borrower. If you don't have a bright line test, you are going to have lenders that are going to be more conservative, denying homeownership for a lot of potential homebuyers.

Mrs. BIGGERT. Thank you. And Mr. Sinks, is it your belief that private capital stands ready to get into the market space when the government vacates?

Mr. SINKS. Yes, it is. We believe we have the capacity to fulfill the space that will be left by the FHA. There is plenty of capital in the industry today. And we also know that—there is a lot of discussion about new entrants coming into the industry. I think once there is greater certainty around—as Mr. Cunningham said—the resolution of QRM and the resolution and the future of the GSEs, then we will most definitely see capital back to the MI industry and therefore we will have capacity.

Mrs. BIGGERT. Thank you. Mr. Scire, are there private sector alternatives to the FHA insurance for homebuyers, particularly at the higher end of the market? Do we have the alternatives now? Or are there alternatives that should be?

Mr. SCIRE. We haven't really done the work to take a look at what that part of the market looks like, so I really can't answer that question. I would be glad to look into it, though, for you.

Mrs. BIGGERT. Okay. Thank you.

Ms. Rosen Wartell—I am sorry. I think they left the second part of your name off up there. Fannie and Freddie had been bailed out by the taxpayer to the tune of over $180 million to date. What potential exposure do taxpayers have to bail out FHA?

Ms. ROSEN WARTELL. As I mentioned in my testimony earlier, I think that there are steps that FHA has the ability to take that could well prevent any exposure. And if there ends up being short-term exposure, much of that has the ability to be repaid from revenue that could be earned over time from these very strong books of business that FHA has. So as Secretary Donovan said, no one should be comfortable, given the limited cushion.

Mrs. BIGGERT. Thank you. I am going to have to yield back. I am over my time. Thank you. Mr. Green from Texas, you are recognized for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman. And I thank the witnesses for appearing. So as not to allow your testimony to be misconstrued at some later point in history, is it correct to say that not one of you has concluded that FHA should be eliminated? If you are in agreement with me, would you kindly extend a hand into the air? I know it is something that you might not ordinarily do at a hearing, but we do this in court with something called voir dire. So if you would, if you think that FHA has a meaningful role in the housing market, kindly raise a hand, please.

All right. For the record, please let it reflect that all of the witnesses have concluded that FHA has a meaningful place in the housing market.

If you think that FHA has been a benefit in stabilizing and helping with the recovery that has not been completed—I understand that we are not there—but do you agree that FHA has been a benefit in helping us to get through this downturn in the market in that it has acted as a countercyclical force? If you agree with this, would you kindly extend a hand into the air?

Let the record reflect that all of the parties agree that FHA has been a countercyclical force in helping us with the recovery.

Now, friends, I am doing this because I have been here long enough now to know that later on, there will probably be some talk of FHA going away. I don't think that this is what your testimony was intended to convey. As a matter of fact, Mr. Veissi, your testimony showed the importance of FHA, which is what I attempted to do earlier as well. And also, it indicates the multiplier impact on jobs. A great number of jobs are created not by FHA itself but when houses are sold, you go beyond just the buyer and the seller to all of the various other industries that are associated with the selling of a home.

Finally, let me ask this: The QRM, important. The QM, important. Do you have a number that you have given considerable thought to that you would like to share today? I don't want to put you on the spot, Mr. Cunningham. But this appears to be an area where you have some degree of expertise. Where are you on the QRM?

Mr. CUNNINGHAM. I am not sure I understand your question.

Mr. GREEN. What percentage would you conclude would be a good number?

Mr. CUNNINGHAM. As I indicated, I think honestly the QM, the Qualified Mortgage, is the better place to start. Focus not on hard guidelines that might be mandated or legislated that could necessitate change in the future but rather focus on the borrower, qualifying a borrower for the mortgage that they are applying for.

Mr. GREEN. I am available to hear other comments because I may not have the opportunity—yes, Mr. Veissi, with the REALTORS®?

Mr. VEISSI. I want to make sure that we understand that the downturn in the real estate—at least I understand the downturn in the real estate market was not because we produced a bad product or we had bad people buying. It was because we had horrible underwriting standards and significantly little oversight. You can take a look at a VA mortgage today with the lowest foreclosure rate across-the-board, and they require zero down. Look, the reality is, if you have a qualified individual who is willing to commit to make the payments and they are reasonably invested in that, that is exactly where you go. That is where you go.

Mr. GREEN. As a matter of fact, there are some persons who cannot afford a downpayment but are paying rent that exceeds what a mortgage would be. And they would be a good risk. But the question is, how do you get to them in a systematic way, such that you don't find yourself underwriting loans that may cost taxpayers some money in the future?

Yes, Ms. Rosen?

Ms. ROSEN WARTELL. May I comment on the QRM? I will note that the statute did not include a downpayment—it listed a numbers of factors as relevant to the characters of QRM exemption and it did not list downpayments. And there is a deep concern that by setting a particular downpayment threshold, you bifurcate the market and create less liquidity in one market, raising the prices and essentially diminishing availability for the borrowers who have those lower downpayment amounts which will drive business to FHA. So I would argue that almost regardless of the threshold, you will have that market bifurcation effect.

Mr. GREEN. I thank all of you. My time has expired. I am one of those who is of the opinion that we can mend FHA, that it has a meaningful role. There is no need to move to some far extreme such that it will no longer be effective and in effect not exist.

Mrs. BIGGERT. The gentleman's time has expired.

Mr. GREEN. And I thank you for being here today, witnesses.

Mrs. BIGGERT. The gentleman from Florida, Mr. Posey, is recognized for 5 minutes.

Mr. POSEY. Thank you, Madam Chairwoman. I would like to thank everyone on the panel. You are all very informative. I think you all brought some good information to us. There is not any of you who didn't enlighten me significantly.

Mr. Sinks, did I understand you to say that you think there currently exists a market sufficient to replace FHA if FHA was to vaporize tomorrow?

Mr. SINKS. We are not advocating that the FHA vaporize, but we do believe that they have a role and if they return to their historical norm in terms of that role, there is enough private capital in the private MI industry to support the market.

Mr. POSEY. Has it always been there?

Mr. SINKS. Certainly, in recent times it has, yes.

Mr. POSEY. Then why did they even go to FHA if there were private alternatives available?

Mr. SINKS. I think it is a combination of factors. Back in 2007 and 2008, the private industry lenders and mortgage insurers tightened up their underwriting guidelines, and the FHA was able to step in and pick up that part of the role. As time has moved on, one of the things we have experienced now, as I mentioned in my testimony, on the conventional loan side, which is the loans that go to the GSE, they have loan level price adjustments in their pricing. And as a result of that, the FHA becomes a better execution, so more consumers are going to FHA. In addition, the downpayment requirement, the difference of 3.5 percent at the FHA versus 5 percent that is generally with the MIs—

Mr. POSEY. Ah, so there is a difference. A downpayment does make a difference then?

Mr. SINKS. Yes, sir.

Mr. POSEY. So it doesn't sound like really truly we have a market that is willing to step in and pick up at the more reasonable downpayment level than actually.

Mr. SINKS. That is correct.

Mr. POSEY. I thought I heard you say that right. And what you said apparently isn't exactly what you meant. But thank you.

Mr. Veissi, if the FHA's more minimal downpayment program was eliminated, what do you think would happen to the market? We have people who are suggesting we raise FHA downpayments to 20 to 30 percent in an effort to make the loans more secure when, as you just mentioned, and an example I often use, VA has a 2.5 percent loss ratio, the lowest of anybody that I know of, and most of their loans are zero downpayment. But should the FHA low downpayment program go away, what do you think the impact would be on the market?

Mr. VEISSI. If we are talking the 20 percent down, we have done some statistical analysis. We figure that probably it would take the normal homeowner—the new first-time homebuyer somewhere between 9 and 14 years to save enough money to make that 20 percent downpayment. In the fragile recovery period that we are in today, you would literally devastate the real estate market by doing something like that. FHA has done an enormous amount of good for not just the real estate market today but for the first-time homebuyer in these last 4 or 5 years. About 75 percent of all first-time homebuyers last year made that purchase through FHA. I can tell you because I do this every day, and I travel the country and speak to our people every day, that trying to extract a loan from a conventional bank is like trying to beat up a rock and get blood out of a turnip. It just ain't happening. So unless there is another alternative way and we have beat this one to death, especially during these tight times, you are going to see the real estate recovery really stagnate. And that is enormously important to understand. Do that, and you really will wrench out the recovery and probably the economic recovery of this country.

Mr. POSEY. Thank you. That is a good world perspective on it actually. Mr. Cunningham, your thoughts on the same thing?

Mr. CUNNINGHAM. I agree with those comments exactly. I think that FHA has played an important part in our fragile housing recovery. I think it provides stability in the housing market, liquidity in the housing market. I think that the proposals for QRM, if we could eliminate the debt-to-income requirements and loan-to-value and focus on QM, I think that would be a significant move in the right direction. I think that it is very important for us to provide a government role in housing to provide liquidity in the marketplace.

Mr. POSEY. So generally, the consensus, I think, is that we don't agree with the concept that the best way to eliminate a large inventory of housing is to make it more difficult to buy them?

Mr. CUNNINGHAM. Correct.

Mr. POSEY. Thank you. Thank you, Madam Chairwoman.

Mrs. BIGGERT. Thank you. The gentleman from North Carolina, Mr. McHenry, is recognized.

Mr. MCHENRY. I just wanted to ask broadly—my colleague on the other side of the aisle asked a few broad questions of the panel. I just want to start by asking whether anyone on the panel would say that FHA having as large a role in the mortgage marketplace is a healthy thing. Would any of you volunteer to say that? Okay. All right. So we are not talking about—there is not a discussion on this committee about eliminating FHA. There is a discussion about fixing it. And you know some of us look at FHA and say, when FHA is playing such a large role in the mortgage marketplace, perhaps there is something severely wrong with the mortgage marketplace, right? Which everybody on the panel—I think you would think, obviously, right? It is sort of a reality here. So to Mr. Sinks, with the temporary conforming loan limits being raised, then October 1st, they went back down under law; and then this Congress acted—I voted against this measure on the House Floor—I think it was bad policy to raise the loan limits back up. So we saw a month of activity when the loan limits went back down. Did you see the private sector filling in where FHA could no longer serve?

Mr. SINKS. Yes.

Mr. MCHENRY. Okay. That is a very elaborate answer. Fantastic. It is a wonderful answer. I love that.

Mr. SINKS. If I may, the announcement that the loan levels are going to drop, typically what happens in the lending community is they will start making those adjustments prior to the effective date. So even though the effective date was October 1st, we were seeing lenders in August and September making those changes. So, it is a definitive yes.

Mr. MCHENRY. So you saw the private capital filling in, right?

Mr. SINKS. Yes.

Mr. MCHENRY. And was that a healthy thing? Did you think that that was a positive?

Mr. SINKS. Yes. We believe that was positive.

Mr. MCHENRY. I ask this, I know it is a very simple and basic question, but there is a lot of debate here. We heard from Secretary Donovan. We have heard from the Administration. They said, it was a healthy thing that the loan limits went back down. Let me just ask broadly of the panel, is that a good thing, that the loan limits go back down for FHA?

Mr. CUNNINGHAM. I would contend that it is not. And I will use North Carolina as an example. I have offices scattered across North Carolina. We have—and I have a loan officer in Charlotte who has been anxious about the FHA increase back to the old limit. And in Charlotte, that would mean increasing from $270,150 to $303,000. But that amount of increase, he has a potential three borrowers waiting in the wings on the FHA's mortgagee letter that are proposing to buy a house that otherwise could not buy a house.

Mr. MCHENRY. Why? Why couldn't they buy it?

Mr. CUNNINGHAM. Downpayment.

Mr. MCHENRY. How much downpayment do they have?

Mr. CUNNINGHAM. How much downpayment? I don't know exactly how much they have.

Mr. MCHENRY. Okay. So this is less about FHA, your example, than about the failure of the rest of the mortgage market?

Mr. CUNNINGHAM. It is actually—

Mr. MCHENRY. My time is limited, sir. So let me just go across the panel.

The loan limits going back down, is that a better thing or a worse thing, in your opinion? If we could just go very briefly. I have 1 minute.

Mr. SCIRE. I think it is an appropriate thing for the Congress to weigh in on this as to what is the market segment in which it expects FHA to operate.

Mr. MCHENRY. Okay.

Mr. CAPLIN. The risk assessment is not at an adequate level to provide an answer.

Mr. VEISSI. Anything that would impact a downpayment and condense the amount of prospective purchasers or the ability for them to get mortgaging would devastate the real estate market, especially now.

Mr. MCHENRY. Okay.

Ms. ROSEN WARTELL. When there is not only availability of mortgage insurance but funding and capital for access that is provided to the secondary market, then FHA's market share should be significantly smaller.

Mr. MCHENRY. Yes. Okay. I appreciate your testimony and your answers on this. I think that the key thing to understand was that FHA and our fellow housing programs were intended for the least among us, not the greatest among us. And when FHA is stepping in, in very high home value areas and subsidizing very high-net-worth individuals, we are simply giving a subsidy to folks who could otherwise get lending elsewhere, not those who are at the margins who are struggling to get into a $100,000 or $200,000 house.

Mrs. BIGGERT. The gentleman's time has expired. The gentleman from California, Mr. Sherman.

We are approaching a vote and also another committee coming into this room. So this will be our last questioner.

Mr. SHERMAN. Thank you.

In reference to the gentleman from North Carolina, he comes from a State without a high-cost area in the State. And so, it is very easy for him to vote against a bill that would prevent a major recession from hitting Los Angeles. But I assure him that if a recession starts in Los Angeles, it will reach to North Carolina.

Mr. MCHENRY. Would the gentleman yield?

Mr. SHERMAN. 20 seconds.

Mr. MCHENRY. I appreciate that. I certainly understand your perspective on it. But when we are talking about Federal policy, subsidizing a $500,000 house is very different than helping somebody who is trying to get—

Mr. SHERMAN. You have never seen a $500,000 house in the San Fernando Valley. I assure you, it is smaller and the people who live in it are more working class than those in the $250,000 houses in much of North Carolina. And that is why having a law that distinguishes between your State and mine is necessary. And if you want to see every home in Los Angeles drop by $100,000, and think it won't hit North Carolina, we are an interconnected economy.

I will also point out that this increase, as temporary as it is, affecting only roughly 10 markets around the country, is not subsidizing the borrowers at over $625,000. Before this panel came in, we heard from the Secretary of HUD, who testified that the loans in amounts between $625,000 and $729,000 outperformed the other loans. They subsidize the FHA's other work. So the people in my district are happy not to see a collapse in home prices and are happy to pay insurance premiums that help subsidize what goes on in North Carolina.

Mr. Veissi, I think you already have it on the record. But if we define "qualifying residential mortgage" as requiring in all cases a 20 percent downpayment, what happens to home prices nationwide?

Mr. VEISSI. We have the physical evidence that shows that you could affect home prices across-the-board as much as a 15 percent downturn.

And I just want to comment for just a second. Real estate is local in nature. It is not across-the-board. You made great mention of the fact that prices in California are not the same as Sevierville, Tennessee, or Houston, Texas, or even Miami, Florida. And you have to be sensitive to the fact that real estate is uniquely different in location, from place to place.

Mr. SHERMAN. So that would be location, location, and location being relevant to real estate?

Mr. VEISSI. Yes.

Mr. SHERMAN. And I would also add to your 15 percent comment, we heard from the earlier panel that if we saw anything over a 4, 5, or 6 percent decline in home values in this country, that would cost FHA—would use up its reserves. And God knows what it does to Fannie and Freddie. But a 15 percent decline in home values nationwide would do more to increase the Federal deficit than anything I can think of. And I have been called a liberal Democrat, so I can think of a lot of things.

The other comment I would make is that, like Mr. Veissi's responses, if we could increase in the high-cost areas Fannie and Freddie, wouldn't that open the door to private mortgage insurance taking some of the risk, diminishing the Federal risk, reducing FHA's role, all the things that some of our colleagues are talking about? Not that I am not grateful for the FHA. But if we could do Fannie and Freddie?

Mr. VEISSI. I think anytime you give private money real comfort in knowing that there exists parameters you are going to have them come back into the marketplace wholesale and be more competitive on that level. And then, FHA will take a much smaller portion of the marketplace. I think that goes without saying. Plus, what you heard from the testimony this morning was that the higher-cost loans had a lesser amount of foreclosure than those even in the smaller places.

Mr. SHERMAN. We may have expensive homes, but we do pay our mortgages. And the final thing I want to point out is this idea that there was no harm, no foul. People prepared for this in high-cost areas, like the area I represent—the gentleman from North Carolina does not—and completed their transactions and their sales in the summer. They were ready to go for a few months. But if we had not gotten that higher FHA, you would have seen a spiraling down in prices.

And for the record, Mr. Veissi is nodding. I yield back.

Mrs. BIGGERT. Thank you. And just for the record, Mr. Scire, are there controls on how much money FHA can draw down from the Treasury?

Mr. SCIRE. So if FHA were to use up the amounts that are in the capital reserve account, they would, in consultation with OMB, draw on permanent indefinite authority to make up whatever difference would be required to replenish what is needed for the financing account through the capital reserve account. So this permanent indefinite authority provides whatever appropriated dollars might be needed in order to make the capital reserve account whole.

Mrs. BIGGERT. So there is no limit?

Mr. SCIRE. No.

Mrs. BIGGERT. Thank you.

The Chair notes that some Members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

Again, thank you. Thank you for your patience, and thank you for being here. You have been very helpful, I think, in bringing your testimony to us, and we thank you so much. And with that, this hearing is adjourned.

[Whereupon, at 2:08 p.m., the hearing was adjourned.]

A P P E N D I X

December 1, 2011

Testimony of Dr. Andrew Caplin

Silver Professor and Professor of Economics
Co-Director Center for Experimental Social Science

New York University

Before the House Committee on Financial Services

For the Hearing Entitled
"Perspectives on the Health of the FHA Single-Family Insurance Fund"

December 1, 2011

EXECUTIVE SUMMARY

I propose two measures to help the Federal Housing Administration (FHA) safeguard its Mutual Mortgage Insurance Fund (MMIF). The first measure involves filling a profound gap in the actuarial review. The second involves expanding access to underlying FHA data to research teams capable of enhancing the risk assessment.

1. A GAP IN THE ACTUARIAL REVIEW

The first measure involves filling a profound gap in the actuarial review. This gap makes it currently impossible to answer two basic questions.

1. What proportion of recent FHA-backed borrowers has defaulted?

2. What proportion is likely ultimately to default?

The centrality of these questions is evident. The answers determine the risks that FHA programs pose to taxpayers in their role as guarantors. They determine the probability that FHA-backed homebuyers will face the trauma of foreclosure. They determine the probability that Congress will be asked to recapitalize FHA's Insurance Fund. They determine the likely timing and size of any such request or requests.

Depressingly, the Actuarial Report does not answer these questions. Rather than projecting the success and failure of FHA-backed **borrowers**, it projects the performance of FHA-backed **mortgages**. This results in down-ward biased loss projections. Work that was initiated some two years ago with Joseph Tracy, Executive Vice President and Senior

Advisor to the President of the Federal Reserve Bank of New York, suggests this bias may be highly significant.[1] There is a far higher probability than currently projected that a large bill will be due taxpayers, that FHA-backed homebuyers will face foreclosure, and that Congress will be called upon to significantly recapitalize FHA's Insurance Fund. History will judge us poorly if we continue to bury our heads in the sand. Neglect is not benign, and time is most definitely not on our side.

While it may sound like a narrow technical issue, the distinction between projecting borrower performance and projecting mortgage performance is of highest practical significance. In recent years the FHA's "streamline refinance" program has been in high demand. In this program, FHA-backed mortgages can be refinanced to prevailing lower rates without any new underwriting. I regard this as an excellent program.[2] The problem is not with the program, but rather with the Actuarial Report, which treats each such refinance as if it represented final termination of FHA's insurance obligation. In truth, there is no cancellation of the underlying insurance and little by the way of additional fees to FHA. By lumping refinancing together with mortgage terminations in which the FHA's insurance obligation is extinguished, e.g. following a successful house sale, the Actuarial Report overestimates both FHA's past success rates and its projected future success rates.

My ongoing work with Joe Tracy suggests that the resulting underestimation of losses is significant. In this period of falling rates and housing market trauma, streamline refinancing appears to have been the most prevalent method of early mortgage prepayment. How could it be otherwise? There has been a significant incentive to refinance, as rates on standard FHA-backed mortgages have fallen from 6.00% p.a. in January 2009 to 5.23% p.a. in January 2010 and 4.51% p.a. in January 2011.[3] In the meantime, there has been little opportunity for turning a quick profit by selling a recently house and moving. If our preliminary findings on mortgage terminations hold up to further work on the underlying data, as we expect they will, default rates on recent FHA mortgages will stay at elevated levels for years after they are currently projected to decline.

I am upset with the slow pace of our progress on this research. Unfortunately reality is not on pause. My first proposal is for HUD to instruct IFE immediately to re-estimate the loss model linking together FHA mortgages that are refinanced one into the other.

2. DATA AVAILABILITY

My second proposal relates to data availability and analytic capabilities. I propose that Congress supply HUD with the additional resources it requires to make data available to

[1] Aragon, Diego, Andrew Caplin, Sumit Chopra, John V. Leahy, Yann LeCun, Marco Scoffier, and Joseph Tracy, 2010, "Reassessing FHA Risk" NBER Working Paper No. 15802

[2] Just such a program was proposed in Caplin, Andrew, Charles Freeman, and Joseph Tracy, 1997. "Collateral Damage: Refinancing Constraints and Regional Recessions," Journal of Money, Credit, and Banking, vol. 29(4), 496-516.

[3] http://portal.hud.gov/hudportal/documents/huddoc?id=fharates_current.pdf

outside researchers and institutions with appropriate analytic capabilities, such as the Federal Reserve Bank of New York. Risk assessment will be dramatically enhanced once additional research teams are encouraged to participate. The resulting improvements will help FHA retain its reputation for helping homebuyers while safeguarding taxpayers.

The hour is late. Let us not fail in our collective responsibility to provide borrowers, taxpayers, and FHA itself with the information they require to effectively measure, mitigate, and manage true risk.

MORTGAGE
BANKERS
ASSOCIATION
Investing in communities

Testimony of Henry V. Cunningham, CMB

Mortgage Bankers Association

Before the

United States House of Representatives
Committee on Financial Services

Hearing on

"Perspectives on the Health of the Single Family Insurance Fund"

December 1, 2011

Chairman Bachus, Ranking Member Frank and members of the committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA) on the recent release of the Federal Housing Administration's (FHA) FY 2011 Actuarial Report, and its findings on the state of the Mutual Mortgage Insurance Fund (MMIF). My name is Hank Cunningham, and I am President of Cunningham and Company, an independent mortgage banking firm with offices throughout North Carolina. Our company was founded in 1990 and we are proud to have helped open the door to homeownership for over 30,000 homebuyers. I have more than 37 years of professional mortgage experience, am immediate past Chairman of MBA's Residential Board of Governors and also serve on MBA's Board of Directors. Thank you for holding this hearing on the actuarial soundness of FHA's insurance fund.

FHA is an essential element of the American housing finance system and is especially important to segments of the population who need a little extra help in securing safe, decent affordable housing – whether through the American dream of homeownership or the foundation of affordable rental housing.

More than any other national program, FHA focuses on the needs of first-time, minority, and low- and moderate-income borrowers. According to recent data provided by the Department of Housing and Urban Development (HUD), both first-time homebuyers and minorities continue to make up a significant portion of FHA's customer base. As of October 2011, approximately 76 percent of FHA-insured home purchase loans were made to first-time homebuyers, and 33 percent of these first-time homebuyers were minorities. Minorities also comprise a higher percentage of the FHA market than the conventional mortgage market.

Last decade, there were discussions about whether FHA was truly necessary, or if the private sector could assume its functions. The significance of FHA in the housing finance system has been underscored, however, by the recent economic crisis that began in late 2008 and resulted in the retreat of the private sector and an illiquid mortgage market. FHA's counter-cyclical role has proven invaluable to maintaining liquidity in the single family market and has helped buttress the country's unstable housing finance system. With the contraction of the private sector, FHA's market share has grown to almost 30 percent of all loan originations and has reached as high as 50 percent in some areas of the country. In 2011, FHA and other government housing programs have typically accounted for 40 to 50 percent of all purchase mortgages, according to MBA data.

The Mortgage Bankers Association has always been a proponent for a strong and vibrant FHA. Our members called for updates and enhancements to FHA's risk management, scope and operations well before the current market disruptions reestablished FHA's prominence as a catalyst for bringing liquidity to the housing finance system. In 2009, MBA created an executive level task force that called for swift and appropriate measures to protect the safety and soundness of the program, including raising net worth requirements for FHA approved lenders, reevaluating credit and underwriting standards, reexamining the insurance premium structure, and establishing sensible consumer and lender protections for the Home Equity Conversion Mortgages (HECM), or reverse mortgages, program.[1]

FHA made a series of single family risk management and lender oversight and enforcement changes over the last two years designed to protect its financial stability, including raising the annual mortgage insurance premium 25 basis points (bps) this year to 110 or 115 bps (depending on the loan-to-value ratio), increasing down payment requirements from 3.5 percent to 10 percent for borrowers with credit scores below 580, eliminating FHA's approval of loan correspondents, raising lender net worth requirements in all programs, re-examining HECM policies, and establishing the Office of Risk Management, which provides risk assessments for all FHA programs. MBA commends HUD and FHA for taking proactive measures in order to reduce taxpayers' exposure.

Although many of the policy changes resulted in fewer approved lenders and slightly more expensive mortgage financing for consumers, the industry believes that it was imperative to put safeguards in place early to ensure the future viability of FHA. These changes put FHA on more stable footing and allowed it to continue to support the housing market.

On November 15, 2011, FHA released its annual Actuarial Report, which provides an update on the financial health of the MMI Fund, a system of accounts used to manage FHA's single family mortgage insurance programs. The report continues to show that the capital reserve account of the MMI Fund is well below the two percent statutory threshold. It has fallen to 0.53percent in 2009, to 0.50 percent in 2010, and now to 0.24 percent in 2011. While the announcement in 2009 that the Fund had fallen below two percent was a major wake-up call, this Actuarial Report is a fresh reminder that the country is still in the aftermath of a significant recession. The two percent target was established by Congress in order to ensure that FHA could withstand the stress of a major housing and mortgage market disruption, an event like the one the industry is currently experiencing.

MBA recognizes, however, that the agency will need to continue to diligently monitor the Fund and make reasonable management decisions to ensure it remains a viable low downpayment option for its targeted population. We support upcoming program changes such as prudently strengthening lender oversight and monitoring, increasing staff of the Office of Risk Management and Regulatory Affairs and integrating that staff into various business lines, and leveraging new technology resources. These changes are necessary to buttress FHA against forces that are beyond the agency's control, such as a sharp decrease in house prices and changes in state foreclosure laws, which could undermine its strategic planning and cause additional stress on the Fund.

[1] *See* Mortgage Bankers Assn., The Future of the Federal Housing Administration (FHA) and the Government National Mortgage Association (Ginnie). (September 2010), http://www.mortgagebankers.org/files/ResourceCenter/FHA/TheFutureofFHAandGinnieMae.pdf.

FY 2011 FHA Actuarial Report

The Actuarial Report provides an assessment of the fiscal health of FHA and its financial outlook. These reports provide a snapshot of the FHA portfolio at a particular point in time, which in this case was the end of FY2011. As expected, the capital reserve ratio of the MMI Fund continues to be below the minimum congressional requirement of two percent. The capital reserve fund is now at 0.24 percent, down from 0.50 percent in FY 2010. Given that the country just went through an extremely severe recession from which it is still recovering, it is not surprising that FHA is experiencing significant losses on loans made prior to the boom, as well as losses on the large volume of new business. Clearly, high unemployment and stagnant housing markets are weighing heavily on the MMI Fund.

Highlights of the Actuarial Report include:

- The capital reserve ratio of the MMI Fund remained positive at 0.24 percent. In the FY 2010 report, the ratio was 0.50 percent. The capital reserve ratio measures *excess* beyond forecasted net claim costs on outstanding loans.

- The Actuarial Report cites several important reasons for the decline in the capital reserve ratio, including:

    - Continued home price declines;
    - Loans from 2006-2008 that are hitting serious delinquency (90+ days) rates above expectations, and have been for over a year, meaning that claims are likely;
    - Seriously delinquent loans that have corrected have a higher re-default potential; and
    - Expectation of more claims due to foreclosures in 2012. (In 2011, the controversy over "robo-signings" delayed many foreclosures. The expectation is that all delayed foreclosures of defaulted loans will ultimately go to claim.)

- FHA's total cash plus investments is estimated at $33.7 billion – $7.7 billion higher than predicted last year by the independent actuaries. This difference is due to a decrease in claims and the impact of the change in insurance premium structure implemented in FY2011 combined with an increase in new insurance endorsements in FY2011, which are close to $11 billion (nearly double that of FY2010).

- The economic net worth (ENW) of the Fund fell by $2.1 billion this year – from $4.7 billion to $2.6 billion – as FHA continued to build loss reserves to prepare for higher expected claims in the coming years.

- FHA assets are $7.7 billion higher than predicted in the FY2010 Actuarial Report due to the premium increase made effective in April 2011, and a slowdown in foreclosures because of the robo-signing controversy.

- The robo-signing controversy caused claims to decrease because some major servicers and states temporarily suspended foreclosures until processes could be appropriately validated. The expectation of the actuaries is that all FHA loans caught up in the controversy will result in a claim payout in 2012.

- The MMI Fund should exceed two percent by FY2014 under the best case scenario, assuming a home price recovery in 2012 and growth in home prices beginning in 2013.

- FHA predicts the chance of the Fund going negative is close to 50 percent. Any cash infusion from the United States Treasury would be for the pre-2010 books. Future home price declines would need to be significant in order to greatly impact the 2010 book of business.

MBA has reviewed the audits of the MMI Fund. These audits used a wealth of data and sophisticated modeling techniques. Different choices of model specifications or economic assumptions might have led to somewhat different results, but these audits appear to have been conducted carefully and professionally, and hence are a valid basis for the important public policy discussion regarding FHA in which we are now engaged. MBA believes that minor specification changes in the default model, or subtle differences in the treatment of the data, would not have yielded significantly different results. Uncertainty regarding the economy is a more important factor.

With regard to economic uncertainty, MBA wishes to underscore that the soundness of FHA's financial position is intricately tied to whether the assumptions and predictions that were used as the basis for the Actuarial Report hold true. While the industry is cautiously optimistic about the growth in home prices over the next few years, MBA recognizes that the economy is in a precarious state and that it is difficult to forecast economic trends, such as interest rates, in such uncharted waters.

Importantly, FHA's capital adequacy requirements are designed to be analogous to those for private institutions – they minimize the likelihood that taxpayers would need to provide funds to FHA. For a private sector financial institution, regulatory capital measures are a key measure of financial health. Banks and other financial institutions set aside reserves to cover expected losses on lending, but also hold capital to cover unexpected losses that may arise from changes in economic or financial market conditions or loan performance. Regulators require financial institutions to hold sufficient capital to minimize the likelihood that they would become insolvent during a crisis. FHA's requirements are modeled after these sound and proven practices.

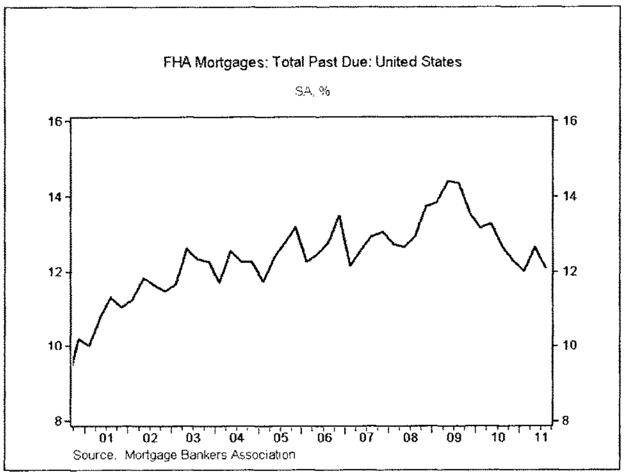
National Delinquency Survey

On November 17, 2011, MBA released its third quarter National Delinquency Survey (NDS) results. While the survey showed that delinquency rates improved in the third quarter, the foreclosure data indicates we are still not out of the woods and that serious issues continue to vary by geography. Depending on location, different trends are driving these results. The increase in the foreclosure starts rate this quarter was driven by large increases from a few servicers, concentrated in certain "hardest hit" states like Florida and California. For most servicers, the foreclosure starts rate was little changed over the quarter. In these "hardest hit" states, the few large changes reflects the progression of delinquent loans through the foreclosure process. Outside of these states, improvement has continued, although at a slow pace due to the weak job market.

The 30-day delinquency rate, the measure of early stage delinquency, reached its lowest level since the second quarter of 2007, a sign that new mortgage delinquencies have slowed. This is an indication that the overall housing market is beginning to recover and should positively impact FHA. Foreclosure starts, however, increased this quarter, the first increase in a year after declining for three straight quarters, and is now back up to the levels of the first quarter of 2011. This trend is largely driven by loans leaving the loss mitigation process and the ending of state remediation programs and foreclosure moratoria.

The percentage of loans in the foreclosure process was unchanged from last quarter but up from the third quarter of last year. The foreclosure inventory rate remains quite elevated, but is at the lowest point since last year. Similar to last quarter, the top five states (California, Florida, Illinois, New York, and New Jersey) in terms of the number of loans in foreclosure make up more than 52 percent of the national total. FHA should closely monitor its concentrations in those states. The disparity in loans in foreclosure between the judicial and non-judicial states continues to widen as backlogs continue with more new foreclosures entering the pipeline.

The FHA data reflects the influence of the overall delinquency trends and its causes (see chart below). Compared to the second quarter of 2011, on a seasonally adjusted basis, the overall delinquency rate decreased for all loan types. FHA loans experienced declines, with the delinquency rate decreasing 53 basis points to 12.09 percent. The seasonally adjusted delinquency rate decreased 42 basis points to 4.32 percent for prime fixed loans and decreased 103 basis points to 10.73 percent for prime adjustable rate mortgage (ARM) loans. For subprime loans, the delinquency rate decreased 138 basis points to 21.24 percent for subprime fixed loans and decreased 211 basis points to 25.07 percent for subprime ARM loans.



The percent of loans in foreclosure, also known as the foreclosure inventory rate, remained unchanged from last quarter at 4.43 percent. The rate for FHA loans increased three basis points to 3.27 percent. The foreclosure inventory rate for prime fixed loans remained unchanged at 2.56 percent. The rate for prime ARM loans decreased 11 basis points from last quarter to 9.05 percent. The rate for subprime ARM loans increased 50 basis points to 22.73 percent and subprime fixed loans saw a decrease of 19 basis points to 10.82 percent.

The non-seasonally adjusted foreclosure starts rate increased five basis points for FHA loans to 0.78 percent and increased seven basis points for prime fixed loans to 0.69 percent, 34 basis points for prime ARM loans to 2.16 percent, six basis points for subprime fixed to 2.50 percent and 103 basis points for subprime ARMs to 4.65 percent.

Compared with the third quarter of 2010, the foreclosure inventory rate increased five basis points for FHA loans, 11 basis points for prime fixed loans, 194 basis points for subprime fixed, and 95 basis points for subprime ARM loans. The foreclosure inventory rate decreased 100 basis points for prime ARM loans.

An analysis of the Actuarial Report and NDS indicates risks to the MMI Fund. MBA recommends that FHA closely monitor its increasing delinquencies, given its continued rise in volume and seasoning of loans. However, FHA's new premium structure, current prudent policies, and strong, experienced leadership should be a bulwark against further decline. FHA is much better positioned to withstand the unpredictable economic future because of the following indicators:

- The FY2011 book of business has an expected economic value of close to $11 billion, nearly double the actuaries' projection for this book in last year's report.

- The credit quality of FHA borrowers in FY2011 continues to improve, with the average decision credit score across all borrowers increasing to over 700. The second quarter of FY2011 had an average borrower credit score of 704, with 38 percent having a credit score over 720.

- Although premium revenue was down in FY2011 (due to lower volumes of new insurance and the change to a greater reliance on annual rather than upfront premiums), over time FHA expects total premium receipts will be higher under the new rate structure.

- Re-defaults from 2010 and 2011 cures are declining from the high reached in 2009. In 2010, re-default declined from 39 percent to 30 percent, a reduction of nine percent.

The Return of the Private Market

A key component of putting private capital on the front lines is to revitalize our secondary mortgage market by updating our housing finance system. Since the creation of Fannie Mae in the 1930s, the federal government has played a key role in providing stability to the secondary mortgage market. The current housing crisis has tested the government's role and led to calls for a fundamental rethinking of how the government plays its part.

MBA has put forward a suggested framework for government involvement in the mortgage markets, with a particular focus on the roles currently played by Fannie Mae and Freddie Mac. MBA's recommendations represent a clear, concise and workable approach to ensuring liquidity to the mortgage market. The proposed framework carefully balances the government's ability to ensure liquidity with the need to protect taxpayers from credit and interest rate risks associated with mortgage finance. It is a plan that promotes the return of private capital while limiting the government's footprint in mortgage finance, helping the markets function efficiently while protecting taxpayers. MBA looks forward to working with Congress on this vital issue.

Another threat to the return of the private market continues to be the outcome of the Qualified Residential Mortgage (QRM) and the Qualified Mortgage (QM) rulemakings. One of the Dodd-Frank Wall Street Reform and Consumer Protection Act's (Dodd-Frank) most significant provisions requires issuers of asset backed securities to retain an economic interest in a portion of the credit risk for any asset that the issuer securitizes. MBA supports the concept of risk retention and believes Congress' intent in crafting this section was to address errant securitizer and originator behavior inherent in the originate-to-sell model by better aligning the interests of borrowers, lenders and investors in the long-term performance of loans.

This "skin in the game" requirement, however, is not a cost-free policy option. Recognizing these costs, Dodd-Frank establishes an exemption from risk retention requirements for QRMs. The QRM exemption was intended to recognize that traditional mortgage loans – standard products, properly underwritten and with appropriate documentation – were not the cause of the recent crisis, and securitization of these loans should remain unimpeded in order to return the U.S. mortgage securitization market to being among the most liquid in the world. By requiring a QRM exemption, the statute would keep consumer costs lower for QRMs, with higher costs for non-QRM loans. MBA believes the proposed regulations and structure of the QRM deviate significantly from what Congress intended and are likely to have a dramatic impact on the housing finance system unless they are substantially revised. MBA recommended several revisions to the proposed regulations in a comment letter submitted to federal regulators on August 1, 2011.[2]

MBA shares the belief expressed by the Obama Administration in its February 2011 report to Congress, *Reforming America's Housing Finance Market*, and countless others that the role of the government, including FHA, in the housing finance market must be rolled back. Yet, the proposed QRM definition produced by the six regulators appears to conflict directly with the administration's plan for reforming the housing finance system, as it would make it more difficult for private capital to re-enter the housing finance market.

It is not at all clear from the proposal whether the regulators reflected on the relationship between the proposed QRM definition and the FHA's eligibility requirements in light of FHA's statutory exemption from risk retention. Because of the wide disparity between FHA's downpayment requirement of 3.5 percent and the currently proposed QRM requirement of 20 percent, MBA is concerned that the FHA programs will be over-utilized.

MBA suggests a better solution to meeting the requirements of Dodd-Frank is to allow the use of credit enhancements, such as private mortgage insurance, to offset part of the downpayment requirement for QRMs to provide some of the financing for low downpayment loans that FHA provide.

Furthermore, MBA believes the QM proposal issued by the Federal Reserve is a better starting point for achieving Dodd-Frank's goal of ensuring that the market originates safe, sustainable mortgage products than the QRM proposal. Section 1411 of Dodd-Frank prohibits making a mortgage loan unless the originator makes a reasonable determination, in good faith, based on verified and documented information at the time the loan is consummated, that the consumer will have a reasonable ability to repay the

[2] *See* http://www.mortgagebankers.org/files/Advocacy/2011/CreditRiskRetentionProposedRuleCommentLetter.pdf

loan, including any mortgage related obligations. Section 1412 provides that if the loan meets the QM definition, it is presumed to meet the ability to repay requirements. The Consumer Financial Protection Bureau is charged with prescribing rules to implement Section 1412.

By statute, FHA-insured mortgages – because of their stringent underwriting requirements and the statutory definition of points and fees – meet the definition of a QM.

MBA believes that because the QRM and QM constructs were intended to achieve the same purpose of ensuring better, more sustainable lending, both constructs should be essentially the same. If a QM definition is well structured as a bright line safe harbor, it will be the chosen means for lenders to comply and, therefore, the best way to incent the sound underwriting mandated by Dodd-Frank.

A QM safe harbor will increase the availability and affordability of credit for the largest number of qualified borrowers, without establishing hardwired numerical limits. The QRM proposal, on the other hand, would have the effect of excluding a large number of borrowers from the most affordable, sustainable mortgage products and directing them into FHA-insured mortgage products, which would not be advantageous to the swift return of the private market.

<u>Sustained FHA Activity and Stabilization of the Housing Market</u>

To ensure the long-term sustainability of FHA and the stabilization of the housing market, MBA recommends the following:

Increased Resources and Operational Efficiencies

MBA believes a critical requirement for achieving, sustaining, and protecting the housing market's long-term vigor is ensuring that FHA has the resources it needs to operate in a modern, high-tech real estate finance industry. MBA thanks Congress for recognizing this and giving FHA almost $599 million for salary and expenses and administrative costs, approximately $7 million more than FY2011, which can be used to bolster FHA's resources and hire quality staff to manage its growing portfolio. Although FHA's market share is likely to decrease in the future as more private capital returns to the mortgage market, we recognize that FHA will still need the resources to manage endorsements for the lifespan of these loans and we support giving FHA the funds and flexibility to do so.

MBA also strongly supports funding to upgrade technology to improve operational efficiencies. New and updated technology would enable FHA to better monitor lenders, protect against fraud, and generally be better equipped to handle the challenges of a modern marketplace. An example of how FHA could modernize its technology for the betterment of consumers and lenders is by permitting the use of electronic signatures (e-signatures) for all mortgage origination forms required by FHA. E-signatures, acceptable under federal law and by FHA on certain documents, would help reduce processing issues that impair the home-buying process. E-signatures would reduce the volume of lost paperwork, reduce the time required to close a loan, lower borrower costs, and reduce signature fraud. MBA has requested that FHA implement a revised policy accepting the use of e-signatures on all of its loan documents. MBA has also advocated that FHA adopt the Mortgage Industry Standards Maintenance Organization (MISMO) single family data standards, as Ginnie Mae, Fannie Mae, and Freddie Mac have done. Data standardization would help FHA improve efficiencies and lower costs.

Lender Enforcement that is Fair, Transparent, and Responsible

MBA supports high standards for all lenders that participate in FHA programs in order to protect FHA's viability, the lender's reputation, and the reputation of the industry. MBA members recognize and accept accountability for instances of fraud and negligence within their control and we appreciate the effort of FHA in providing increased risk management policies to ensure the future financial security of its insurance funds, including necessary lender enforcement efforts.

Heightened enforcement of lenders is useful and necessary, but requires due process. Lenders incorporate sophisticated quality control systems to minimize the possibility of indemnifications. MBA supports FHA's efforts to rid the industry of lenders who do not uphold these high standards; however, we strongly advocate for FHA to establish policies and processes that are fair, clear, and transparent, and which allow lenders to have sufficient opportunity for appealing decisions and remediating problems. MBA looks forward to working with this committee and FHA on upcoming changes that address this very serious issue.

Real Estate Owned Properties Disposition that Encourages Neighborhood Stabilization

On September 15, 2011, MBA responded to the Request for Information (RFI) issued by the Federal Housing Finance Agency (FHFA), in consultation with HUD and the Department of Treasury that solicited recommendations for addressing the real estate owned (REO) properties in Fannie Mae, Freddie Mac, and FHA's portfolios. Policymakers and MBA recognize that housing's supply and demand imbalance must be resolved before the country can fully recognize a sustained economic recovery. Although the focus of the RFI was to reduce the agencies' inventories through bulk sales, MBA believes a multi-pronged approach that includes encouraging owner-occupancy, local investors and bulk sales is the best way to address the significant over-supply of housing and the unique real estate characteristics in some parts of the country. As part of this approach, one of MBA recommendations was to expand finance options for local investors, including lifting the moratorium for investors in FHA's 203(k) program.

MBA believes a top priority during this transition should be to stabilize neighborhoods and long-term home prices through actions that reduce the overhang of distressed properties. A reduction in the current REO inventory will provide for the swiftest and most efficient return to market stability. As the country moves to correct the supply and demand imbalance, it is critical that policymakers balance taxpayer interests, investor interests, and consumer protections to ensure responsible asset disposition.

Local investors understand their particular markets and have a long-term stake in the stabilization of their neighborhoods. Providing affordable, responsible financing options to investors not only eliminates REO properties, but also empowers neighborhoods by giving local residents an increased stake in its success. These tools would be especially beneficial in urban neighborhoods that face the challenges of older housing stock and neighborhood blight.

FHA should introduce an investor program – specifically one that includes a renovation option. One solution would be to temporarily lift the moratorium on investors participating in FHA's Section 203(k) Rehabilitation Loan Program. The Section 203(k) program helps buyers of properties in need of repairs reduce financing costs, thereby encouraging rehabilitation of existing housing. With a Section 203(k) loan, the buyer obtains one FHA-insured, market-rate mortgage to finance both the purchase and rehabilitation of a home. Loan amounts are based on the lesser of the sum of the purchase price and the estimated cost of the improvements or 110 percent of the projected appraised value of the property, up to the standard FHA loan limit.
HUD began promoting Section 203(k) to homeowners, private investors and non-profit organizations in 1993. Private investors were often able to find undervalued properties, renovate them and sell them for more than the purchase price plus the cost of improvements, or provide much needed rental housing. Motivated by this profit potential, many investors successfully renovated and sold properties ranging from individual homes to entire blocks, thereby expanding homeownership opportunities, revitalizing neighborhoods, creating jobs, and spurring additional investment in once blighted areas.

In 1996, however, following a report by HUD's Inspector General describing improprieties concentrated in New York and insufficient departmental oversight, HUD placed a moratorium on all Section 203(k) loans to private investors. The Inspector General noted rampant fraudulent activity that resulted in financial gain for the participants and un-rehabilitated houses in the neighborhoods.

MBA agrees that safeguards in any program are necessary to prevent abuse and to ensure that the program meets its intended purpose. MBA recommends that FHA lift the moratorium on investors participating in the 203(k) and reinstate it as a pilot to facilitate the purchasing and rehabilitating of REO properties by local investors. In recognition of the historical abuses of the program, MBA also recommends that the program be modified to ensure responsible lending and minimize fraudulent activity. MBA's members welcome the opportunity to work with FHA to develop a program that meets these criteria.

Support of the Home Equity Conversion Mortgage Program

In 2011 and 2012, FHA took steps towards ensuring that the HECM reverse mortgage program remains a viable financing option for seniors. During the past 15 months, FHA has made significant programmatic changes including introducing the HECM Saver for borrowers who want to borrow less than the maximum amount available under the standard HECM; adjusting the principal limit factors used to determine the maximum claim amount for a HECM loan to assure that the HECM Standard could be self-supporting; providing guidance to lenders regarding the treatment of taxes and insurance defaults by HECM borrowers; and increasing HECM annual premium rates from 0.50 percent to 1.25 percent.

FHA also reiterated in October 2011 that the HECM program criteria is only a baseline standard for lenders and that lenders can include additional financial capacity and credit assessment criteria and processes in the origination and approval of HECMs. MBA appreciates that FHA continues to work as a partner with lenders to strengthen the HECM program and to ensure that borrowers are able to meet their financial obligations related to the mortgage.

Although the HECM program required a transfer of $535 million from capital accounts in FY2011, HECMS are less impacted by near-term economic conditions than the forward mortgages book of business. The Actuarial Report states that because of the programmatic changes FHA implemented, the funds injected into HECM are expected to be paid back in a relative short period of time – by 2015. MBA strongly supports the HECM program and applauds FHA for proactively taking steps to protect a program that is becoming an increasingly important financial option to American seniors.

Support of Housing Counseling Programs

MBA appreciates that the House and Senate restored $45 million to the FY2012 HUD budget for counseling. These funds support the delivery of a wide variety of housing counseling services to potential homebuyers, homeowners, low- to moderate-income renters, and the homeless. Counselors provide information to help households improve their housing conditions and choices, avoid foreclosure, and understand the responsibilities of tenancy and homeownership.

Funding for counseling is especially critical to seniors because the statute authorizing the HECM program mandates that reverse mortgage counseling be a requirement for receiving a reverse mortgage. Because FHA policy bars lenders from paying for reverse mortgage counseling (to eliminate any conflict of interest), the reverse mortgage counseling fee becomes the borrower's responsibility. Regrettably, seniors who need the proceeds of a reverse mortgage the most are the ones least likely to afford the counseling fee.

Counseling remains a valuable component of the homebuying process and MBA looks forward to working with Congress on increasing resources for this very necessary program.

Multifamily

Although not the focus of the hearing today, MBA believes that it is important to take this opportunity to highlight a few multifamily issues. With the decline in the homeownership rate from 69 percent in 2006 to 66 percent in 2011, the importance of multifamily rental housing has been underscored from both public policy and demographic perspectives. As the number of renter households is expected to continue to increase substantially over the next decade, FHA is poised to provide essential support to this market. Since the inception of the housing crisis, FHA's countercyclical impact has been pivotal to maintaining liquidity and stability in the multifamily and healthcare sectors.

MBA commends FHA and its multifamily staff for its work. FHA's endorsement of $11.605 billion in multifamily rental housing loans in FY2011 is impressive, and the performance of FHA-insured multifamily loans remained strong, with very low default rates.[3] MBA is also grateful to Congress for approving an increase in the FY2012 commitment authority for FHA multifamily and healthcare programs.

As a result of unprecedented market demand and volumes, however, FHA's resources have been strained. The backlog in the pipeline of applications has historically been an issue but the unprecedented market demand and volumes have created additional strain to the system, with delivery times getting increasingly long. Because of its impact on local economies, FHA's multifamily programs foster employment while supporting rental housing. We urge Congress to maintain its full support of such programs.

Conclusion

MBA appreciates FHA's vital role in providing liquidity to our nation's distressed housing markets and the traditional countercyclical role it is playing in promoting an economic recovery. We are also grateful for the steps the agency has taken to place itself on surer financial footing and avoid the need for taxpayer funding.

While FHA is not projected to need assistance, there is a real risk that it could require taxpayer support. We think that many of the changes FHA has already made have positioned the program to fare better in the years ahead, but additional changes could further bolster the fund. MBA stand ready to work with Congress and FHA to ensure the agency continues to provide homebuyers with safe, affordable mortgage financing, while also encouraging the return of private capital that will take some of the strain off FHA's programs.

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[3] *See, e.g.*, Ginnie Mae, Office of Mortgage-Backed Securities, Presentation at the 2011 Midwest Lenders Association (May 2011) (reflecting multifamily portfolio delinquencies as of March 2011 at *1.3 percent*).

U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410

Written Testimony of Secretary Shaun Donovan
Hearing before the House Committee on Financial Services
Status of the FHA Mutual Mortgage Insurance Fund and the FY 2011 Actuarial Report

Thursday, December 1, 2011

Chairman Bachus, Ranking Member Frank, and Members of the Committee, thank you for the opportunity to testify regarding the status of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund (MMI Fund or Fund).

As the Members of this panel are aware, FHA continues to perform a vital role in the ongoing recovery of our housing market and broader economy. Not only is FHA permitting families to realize the dream of home ownership, but through partnership with thousands of mortgage brokers and lenders nationwide, FHA is contributing to the stabilization of the nation's housing finance system as it recovers from the recent recession. These activities are central to the realization of FHA's mission of more than 75 years to support adequate flows of mortgage capital in good times and bad, and to act as a countercyclical force during downturns in the nation's mortgage markets.

On November 15, 2011, HUD delivered its fiscal year (FY) 2011 Report to Congress on FHA's financial status. The *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2011* summarizes the results of the independent actuarial report prepared by Integrated Financial Engineering (IFE) and provides a status report on the fiscal health of the MMI Fund. As the report makes clear, FHA remains resilient and continues to play a critically important role in our housing markets. Just as important, the report demonstrates that over the last two and a half years, even as the country's housing markets have continued to face serious challenges, FHA's new books of business have been of extremely high quality. Indeed, the independent actuary projects that the MMI Fund capital reserve ratio will return to a level above the required 2 percent in 2014.

Today, I would like to discuss with you the status of FHA's activities and finances, as well as the steps that this Administration is taking to ensure the rapid restoration of the MMI Fund capital reserve ratio and the ongoing sustainability of FHA's single family programs.

FHA's Role in the Nation's Housing Market

Throughout its history, FHA has helped to ensure adequate flows of mortgage capital for low- to moderate-income, minority and first-time homebuyers. This has been especially true during periods of difficulty or disruption in the mortgage markets when the flow of private capital is reduced. Again in FY 2011, FHA provided much needed assistance to these underserved communities while acting as a countercyclical force to a housing industry faced with the most severe economic conditions since the Great Depression.

FHA insured $236 billion in mortgages in FY 2011, providing access to credit for over 770,000 homebuyers – over 585,000, or 75%, of whom were first-time buyers. FHA also enabled more than 440,000 homeowners to save an average of $160 per month on their mortgage payments through refinancing at today's historically low interest rates. All told, over the past three years FHA has made homeownership possible for 2.27 million first-time buyers. According to annual surveys performed by the National Association of Realtors, FHA supported 56 percent of all first-time buyers in 2009 and 2010.[1]

Additionally, FHA provided significant support in FY 2011 for minority homebuyers and minority homeowners seeking to refinance their properties to lower monthly housing costs. Among those borrowers who disclosed their race, 30 percent of FHA home-purchase endorsements and over 15 percent of refinance loans were for members of minority communities. According to the 2010 Home Mortgage Disclosure Act (HMDA) lender activity report data, FHA continues to lead the market in support for minority homeownership. While FHA insurance was used for 37 percent of all (owner-occupant) home-purchase borrowers, its share of minority borrowers was 46 percent.[2] Indeed, 60 percent of African Americans and 59 percent of Hispanics and Latinos used FHA insurance to buy a home.

[1] Survey results are published in the National Association of Realtors *Profile of Home Buyers and Sellers 2010*., and *Profile of Home Buyers and Sellers 2009* reports. The FHA share of first-time buyers is highlighted in press releases that accompanied publication of those reports:
http://www.realtor.org/press_room/news_releases/2009/11/survey_record ;
http://www.realtor.org/press_room/news_releases/2010/11/survey .

[2] The FHA share when loans with white borrowers but minority co-borrowers are included as minorities is 45 percent. FHA shares are slightly lower when investor loans are included in the totals. However, FHA does not currently insure investor/rental or vacation-home loans.

While FHA continues to play an elevated role in the nation's mortgage finance system, we remain committed to shrinking the government footprint in the market. And there are encouraging signs that private capital is starting to return. Indeed, in FY 2011, FHA loan volume decreased by 34% from its peak in FY 2009, and total market share declined for the first time since 2006.

As FHA offers access to homeownership for borrowers, this Administration has made substantial efforts to ensure that it is extending credit to qualified borrowers who will have the ability to sustain this opportunity over time. Those efforts are bearing fruit. For all of FY 2011, the credit quality of borrowers utilizing FHA insurance set a new record high, with the average score across all borrowers breaking 700 for the first time ever. FHA saw a three-year rise in credit quality of new FHA-insured borrowers, and throughout all four quarters of FY 2011, more than one-third of FHA borrowers possessed credit scores at or above 720. By contrast, in the second quarter of 2008, the share of such A-grade borrowers was under 10 percent.

Additionally, FHA continues to see improvement in its mortgage delinquency rates. The overall delinquency rate for FHA-insured loans was relatively stable throughout FY 2011. FHA has experienced a dramatic decline in the rate of early payment defaults (EPD) over the past three years, indicating that new loans originated in the past few years are of significantly higher quality than those originated prior to this Administration. This decline can be attributed to both the policy changes that have been made to improve the quality of loans insured by FHA, as well as better underwriting by lenders working to align with FHA's strengthened monitoring and evaluation of lender compliance with FHA requirements. EPDs are defined by three consecutive missed payments within the first six payment cycles. Among home purchase loans, the incidence of such EPDs for loans originated in early 2011 was less than one-sixth the rate seen in early 2008. For fully-underwritten (non-streamline) refinance loans, the EPD rate in early 2011 was just one-ninth of its peak in mid 2008. For streamline refinance loans, the improvement has been most dramatic, with the early 2011 rate being only one-twelfth of what it was at the peak in mid 2008.

For those borrowers who face difficulties in meeting their mortgage obligations, FHA has continued to provide much needed assistance through its loss mitigation programs. In FY 2011, FHA loss mitigation tools were used to cure 362,000 defaults, and yielded the lowest re-default rates of the past five years. An additional 142,000 distressed homeowners had their monthly payments reduced through loan modifications. Since the start of this Administration, FHA has provided over 1 million loss mitigation and early delinquency interventions for borrowers. In addition to helping responsible borrowers weather difficult times, these loss mitigation efforts also help minimize losses to the MMI Fund.

The FY 2011 Actuarial Review of FHA's MMI Fund

The condition of the Mutual Mortgage Fund and an analysis of its short- and long-term health are explained in the FHA's report to Congress. The independent actuarial studies use statistical models to predict default, claim, loss-on-claim, and prepayment rates on current and future books of business. Those models are estimated using historical patterns of FHA-insured loan performance under a wide variety of economic conditions. They are applied to active loans, and they use commercially-available forecasts of home prices and interest rates to predict loan performance in the future. The resulting projections determine business operation cash flows needed to estimate the economic value of the Fund.

The MMI Fund operates with two primary sets of financial accounts.[3] First, all business transactions related to insurance operations are maintained in a series of Financing Accounts at the U.S. Treasury.[4] Then, secondary reserves for unexpected claim expenses are maintained in a separate Capital Reserve Account, which is also held at the U.S. Treasury.

FHA's MMI Fund programs, like all federal government direct-loan and loan-guarantee programs are subject to the Federal Credit Reform Act, which provides "permanent indefinite authority" to cover increases in costs for outstanding loans and loan guarantees. For example, if there is an extraordinary increase in actual or expected claims the authority under FCRA provides access to funds to cover the increase in cost. Thus, FHA programs always have access to sufficient funds with which to pay insurance claims. That would be true even in the absence of a Capital Reserve Account.

At the end of FY 2011, the MMI Fund had $33.7 billion in account balances with the U.S. Treasury. Of that total, $29.0 billion was in the Financing Accounts and $4.7 billion in the Capital Reserve Account. Total capital resources at the end of FY 2011 were $400 million higher than at the end of FY 2010, and $1.9 billion higher than at the end of FY 2009. They were also $7.7 billion higher than was predicted last year by the independent actuaries.

[3] There are two additional sets of accounts that are independent of the insurance operations, and for which funds are directly appropriated by the Congress each year. The first is the set of Program Accounts which cover all personnel and administrative expenses for FHA operations. The other is the Liquidating Account, which represents remaining cash flows each year on pre-1992 insurance endorsements. The year 1992 marks implementation of the Federal Credit Reform Act of 1990 and introduction of the Financing Accounts.

[4] There are individual Financing Accounts maintained for each annual book of business, or what are called budget cohorts. There are also separate accounts for forward loans and for HECM.

The actuarial review weighs these balances against the accrued liabilities of FHA insurance currently in force. The review estimates these liabilities at $30.8 billion. So on net, the independent actuarial assessments find that the MMI Fund estimated economic net worth stands at $2.6 billion, representing a capital reserve ratio of 0.24 percent. Last year, the estimated capital ratio was 0.50 percent and the estimated economic net worth was $4.7 billion.

Some major reasons for the year-over-year decline in estimated capital position include the following. First, according to the forecast by Moody's Analytics, which was used by the actuaries for their analysis, home prices are estimated to have fallen 5.6 percent in 2011, which would further impair the value of books already underwater. Second, more loans, particularly from the years of the housing bubble from 2006-2008, are currently in serious delinquency, and a significant percentage have been there for more than one year. For extended delinquency loans, many of which are in foreclosure processing, eventual claim becomes the most likely outcome. Third, more active loans have had a previous serious delinquency (3 months or more), and their (elevated) re-default potential is now built into the actuarial calculations. The independent actuaries made a decision to treat foreclosure actions likely affected by so called robo-signing problems as expected claims in 2012.

By incorporating these projections into this year's actuarial analysis, the independent actuary is accounting for further negative events in the course of the nation's continued economic recovery.

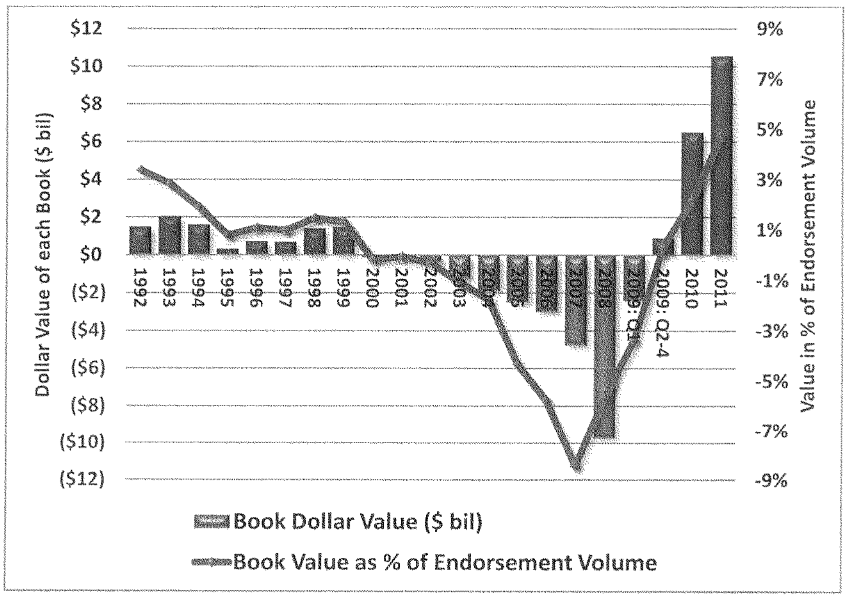
Despite these projections, the review also made clear that under base-case economics the Fund will remain positive, and its prospects for the future are good. The actuaries found that FHA's current underwriting and premium structure have created an actuarially sound basis for growing capital at a rapid rate once the economy and housing markets experience steady and sustained growth. And base-case projections estimate that the capital ratio will reach 2 percent again in 2014, sooner than was projected in last year's report.

The actuaries' review also shows that the stress on FHA's resources is primarily caused by the poor quality of loans insured prior to 2009. By contrast, those loans insured from 2009 onward are performing well. Indeed, final losses on the 2000-2009 Q1 books are expected to exceed $26 billion, and 2008 alone could have a net final cost of close to $10 billion. The actuaries predict that claim rates on the 2006 – 2008 books could each surpass 20 percent.

In addition to being originated near the peak of the housing bubble, the 2007 and 2008 books were also heavily affected by seller-funded downpayment loans. Those loans were eliminated by Congress as of October 2008, so they disappear from new endorsements starting in January 2009. However, their ongoing effect on the financial status of the MMI Fund is still measurable.[5] The independent actuaries estimate that economic net worth would be higher by over $14 billion had such loans never been insured.[6]

In contrast, single family books of business insured under this Administration are expected to provide significant negative subsidy receipts to offset losses on earlier endorsements. Net income generated by the 2009 Q2 – 2011 books is expected to be $18 billion. The stark contrast in the quality of FHA business under this Administration compared to that insured prior to 2009 is clearly visible in Figure 1 below.

Figure 1. Estimated Lifetime Value of Each Single-Family Book of Business, 1992-2001



Source: U.S. Department of HUD/FHA.

[5] Their on-going effect is not only in remaining home purchase loans that could still result in an insurance claim, but also through streamline refinancing that brought many of the 2005-2008 loans into the 2009 and even 2010 books.
[6] The net expected cost of those loans, as projected by the independent actuaries, grew by $1.8 billion over the past year to $14.1 billion.

In spite of the actuaries' determination that the MMI Fund will remain positive under base-case economic scenarios, potential risks to the fund remain. While the actuaries predict that recovery of MMI capital will occur quickly as a result of the historically-high premium rates charged today, as well as by controls put in place over the past two years to avoid the possibility of a repeat of the adverse selection that affected FHA prior to 2009, the principal unknown for the future remains how and when housing markets will consistently and fully recover. Significant further declines in home prices could create a situation in which the current portfolio would require additional support.

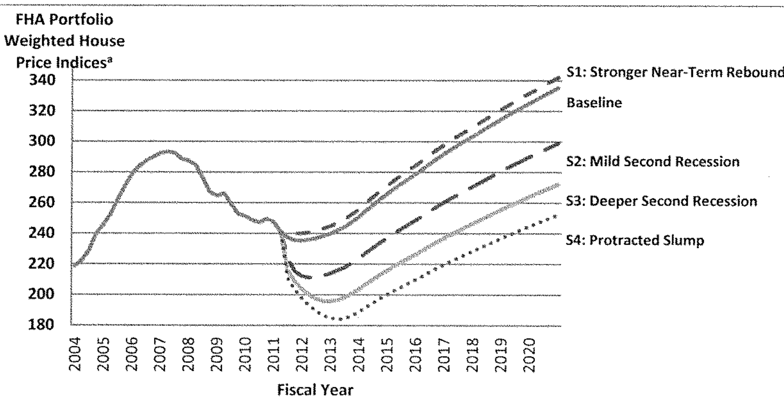
The base-case economic forecast used by the independent actuaries is the median expected path of the economy over the next five-to-ten years, as determined by Moody's Analytics.[7] Moody's Analytics provides four alternative short-run economic scenarios in addition to the base-case. One is an optimistic case, in which home prices start to rise immediately. The other three represent successively worse housing market conditions over the 2012-2013 period. Specifically, the scenarios presented are: a stronger near-term rebound (S1), a mild second recession (S2), a deeper second recession (S3), and a protracted slump (S4). Moody's defines the chance of each alternative in terms of percentiles in an overall distribution of potential economic outcomes. Those percentiles for each of these four scenarios are the 10^{th} (S1), 75^{th} (S2), 90^{th} (S3), and 96^{th} (S4). Each represents a position within the total range of economic environments that Moody's predicts are possible over the next several years.

The base-case scenario indicates price declines in 2011 of 5.6% and predicts a small amount of growth in prices in 2012 (1.3%), followed by more steady growth starting in 2013. Nevertheless, negative house price growth, rather than stable or growing prices as reflected in the base-case forecast, could create a situation in which future net losses on the current, outstanding portfolio could exceed current capital resources. For the long-term, even a period of stagnant house prices would adversely affect the FHA fund.

It should be noted, however, that the "Mild Second Recession" scenario utilized by the actuaries poses an additional 9 percent decline in home prices beyond the 5.6 percent base-case decline, for a total two-year decline of 14.6 percent. In contrast, the worst 2-year period recorded by the FHFA was from Q2 2007 to Q2 2009, when prices fell just under 13 percent. Thus, even the Moody's "Mild Second Recession" scenario is worse than the worst declines experienced since the start of the recent economic crisis. Figure 2 shows the various scenarios utilized by the actuaries for their projections. All these scenarios assume steady and significant house price growth after finding various low points in 2012. Should price declines continue beyond 2012, however, the condition of the FHA fund would worsen.

[7] The FY 2011 independent actuarial studies used Moody's July 2011forecasts of house prices, interest rates, and mortgage originations, along with age-group population growth projections of the U.S. Bureau of the Census.

Figure 2. House Price Paths used by Independent Actuaries for Sensitivity Analysis



[a] Portfolio weighting involved creating weighted average national price growth rates using metropolitan level forecasts and FHA active insurance volumes in **each** MSA (and non-metro areas) as of July 2011. Index values equal 100 in 1995 Q1.

Source: Analysis by the U.S. Department of HUD/FHA using historical and Moody's Analytics' forecasts of the FHFA all-transactions house price index at the metropolitan level, as adjusted by IFE Group.

For the near term, any worsening of economic conditions in 2012 that creates a diminished value on the current, outstanding portfolio in excess of approximately $7 billion would put the MMI Fund in a position where additional support would be required. Should it be necessary, the first place where additional support for the current portfolio would come from is net receipts on new endorsements. FHA could also implement policy changes, such as insurance premium increases, to provide further support to the Fund.

Only if conditions worsened substantially would the losses exceed amounts available in the MMI Fund next year. In this case, the Federal Credit Reform Act of 1990 provides for permanent and indefinite budget authority for any increase in the cost of outstanding direct loans and loan guarantees, including FHA MMI guarantees.

Managing Risk to the Fund

Program Policy Changes

While the Fund has remained positive, we are keenly aware of the importance of remaining vigilant to the risks the agency faces and will continue to take the actions necessary to protect the Fund and taxpayers. Indeed, such vigilance has been the hallmark of the current Administration. Having taken office in the midst of the greatest recession since the Great Depression and faced with a housing market in crisis, this Administration acted immediately to strengthen FHA and protect its insurance Funds by instituting the most sweeping reforms to credit policy, risk management, lender enforcement, and consumer protection in FHA history.

First, beginning in 2010, FHA raised its mortgage insurance premiums three times, actions that were made possible in part as a result of legislation passed by Congress. As we have frequently said, FHA greatly appreciates the key role that was played by this committee in that effort. Thanks to those actions, FHA's current premium levels are the highest they have ever been in the agency's history. The new annual mortgage insurance premium structure alone led to an increase in the FY 2011 economic value of the MMI Fund of $1.37 billion. It should also be noted that due to today's historically low interest rates, FHA has been able to strengthen the MMI Fund through its premium increases without jeopardizing housing affordability.

Continuing our progress, last year FHA implemented a "two-step" credit score policy for FHA borrowers. Those with credit scores below 580 are now required to contribute a minimum down payment of 10 percent. Only those with stronger credit scores are eligible for FHA-insured mortgages with the minimum 3.5 percent down payment.

In addition, a final rule will soon be published that outlines changes to FHA's requirements regarding seller concessions. Allowable seller concessions will be reduced and are never to exceed actual closing costs. These changes will accord with industry norms regarding seller concessions and better protect the MMI Fund from risks associated with inflated appraisal values.

FHA has also made significant changes to the HECM program. In September of 2010, FHA introduced the HECM Saver product as a second option for reverse mortgage borrowers. The HECM Saver offers significantly reduced upfront loan closing costs for mortgagors who wish to borrow less than the maximum amount available under a standard HECM loan. In addition, FHA adjusted the principal limit factors used to determine the maximum claim amount for HECM loans to assure that HECM Standard could be self-supporting. Finally, FHA provided guidance for lenders regarding the treatment of tax-and-insurance defaults by HECM borrowers. These policy measures have significantly strengthened the HECM program so that it can continue to provide important financial options for seniors without posing unnecessary risks to the MMI Fund.

Changes have also been made to the condominium program, including the introduction of a project re-approval and recertification process for FHA-approved condominium projects, as well as a comprehensive revision of FHA's Condominium Project Approval and Processing Guide. These changes ensure the compliance of condominium projects with FHA requirements while updating those policies to better accord with industry trends and norms.

HUD also made changes to its loss mitigation requirements to increase the use of trial payment periods prior to a mortgagee executing a Loan Modification or Partial Claim action to cure a default. Trial payment plans are expected to reduce re-default rates on loan modifications and partial claims, and thereby reduce costs to the FHA Insurance Fund.

Lender Oversight and Enforcement

Just as significant as the changes made to FHA's loan programs has been the strengthening of its oversight and enforcement for FHA-approved lenders. Starting with heightened approval requirements for lenders, FHA is ensuring that it partners with stable and responsible lenders, and that HUD's limited oversight resources are focused appropriately on the entities that pose the greatest potential threat to FHA's insurance funds. Indeed, as a result of FHA's heightened oversight of lenders, over the past three fiscal years HUD has withdrawn the approval of over 1,600 lenders to participate in FHA programs, while protecting the fund through indemnifications and required repayments of improperly originated loans, and the imposition of more than $10 million in civil money penalties and administrative payments..

Additionally, FHA has made substantial changes to its targeting and execution of loan file reviews. Utilizing risk-based targeting that employs a wider array of potential risk factors than has been used previously, FHA has enhanced its ability to identify the lenders and loans that most warrant closer inspection by HUD. In so doing, FHA is better able to prevent unwarranted risks to the MMI Fund.

Risk Management at FHA

Integral to the long-term sustainability of the MMI Fund is a culture of decision making at HUD that emphasizes the importance of risk management. An effort that began with this Administration is the development of the Office of Risk Management and Regulatory Affairs (ORMRA) within the Office of Housing. This new Office provides for a central focus on risk tolerance, risk exposure, and risk management for each of the various FHA program areas. The complete establishment and integration of the Office within FHA are top priorities for HUD. While there is still work to be done to fully establish a comprehensive risk-management framework, significant progress has already been made.

Over the past fiscal year, ORMRA has hired over 15 new employees. These hires bring with them a diverse background in risk management, covering all of FHA's core lines of insurance business. Following the transition of the first Deputy Assistant Secretary for ORMRA, Bob Ryan, to a new role as special advisor to the HUD Secretary, a Senior Advisor for Risk has recently joined FHA to provide continued leadership and expertise in risk management.

The risk management office has become a significant part of the business operations within FHA. As partners to each business line and program area, the risk managers are involved in a wide array of policy and operational decision making processes. On a monthly basis, formal meetings are held between ORMRA and each of the business lines to discuss emerging risks, recent trends, and policy updates. In addition, ORMRA provides substantial capacity for risk monitoring and reporting, and for general portfolio analysis. Over the next fiscal year, ORMRA has plans to further enhance its analytical capabilities with a variety of new tools.

It should also be noted that the GAO conducted an audit entitled, "Federal Housing Administration: Improvements Needed in Risk Assessment and Human Capital Management," that examined the integration of ORMRA activities with FHA operations, as well as FHA's broader workforce planning mechanisms. The GAO Report found that in general HUD was making significant progress in its incorporation of risk management activities and the assessment and development of its human capital. HUD agreed with the audit's recommendations to continue these activities and felt that the audit provided helpful analysis of the current state with regard to risk management and human capital development within FHA. FHA was already at work to implement many of the GAO's recommendations prior to the start of the audit and will utilize the audit in its continued efforts to manage risk and human capital.

Leveraging Technology to Manage Risk and Protect the Fund

In addition to the steps HUD has taken to strengthen the MMI Fund via policy, process, and organizational changes, the Department is also engaged in a large-scale effort to acquire and employ a modern financial services information technology environment to better manage and mitigate counterparty risk across all of FHA's insurance programs. The FHA Transformation Initiative will enable risk detection and fraud prevention by capturing critical data points at the front-end of the loan lifecycle, and leveraging risk and fraud tools, rules based technology, and transactional controls to minimize exposure to FHA's insurance Funds.

These tools will enable FHA to leverage 21st century information technology systems to manage risk at all points of the loan lifecycle. For example, the FHA Transformation Initiative will automate the application process for FHA lender approval, and will provide enhanced data validation capabilities for the evaluation of lender applications. In addition, the initiative will also provide risk analytics mechanisms to identify and manage risk-based exceptions for inbound endorsements and appraisals, permitting FHA to address these concerns at the loan level. Finally, the initiative will provide FHA with comprehensive portfolio analysis tools by which it can identify and evaluate current and emerging risk trends in order to more effectively take appropriate action to avoid or mitigate risks to the MMI Fund.

Managing Risk at Ginnie Mae

I also appreciate the Committee's request for information on the steps Ginnie Mae is taking to improve risk management. Created more than 40 years ago to facilitate a secondary market for government-insured products, Ginnie Mae has performed extremely well throughout its history, Nearly every year of its existence, it has generated profits for U.S. taxpayers. In Fiscal Year (FY) 2011, Ginnie Mae earned $1.2 billion; it was Ginnie Mae's best earnings year ever. Net income in FY 2011 exceeded FY 2010's net income of $541 million and topped the previous high of $908 million set in 2008. This equates to a negative subsidy of $991 million in 2010 and $841 million in 2011. In addition to reporting substantial income for FY 2011, Ginnie Mae has accumulated retained earnings, or capital, of approximately $15.7 billion, which will serve to cushion it against further economic upheaval. These financial results are based on conservative accounting standards and certified by an external auditor.

Ginnie Mae has achieved this strong performance in the midst of the worst housing crisis the nation has experienced since the Great Depression. Over the last three years, it has managed a large increase in business volume; its share of the market rose from approximately 5 percent to approximately 40 percent in some months following the start of the crisis. Ginnie Mae's market share now stands at approximately 26 percent. Further, the crisis not only brought large increases in business volume; but also brought an influx of new lenders seeking to join Ginnie Mae's MBS program, and an increasingly complex set of risks resulting from the difficult economic environment.

The possible failure of a large counterparty is the primary risk that exposes Ginnie Mae and taxpayers to a negative financial impact. At Ginnie Mae, counterparty risk is managed by tightly controlling entry into the program and by closely watching the performance of counterparties after approval. In an effort to enhance its front-end risk management practices, during the last two years Ginnie Mae has increased net worth requirements across all of its business lines and has implemented new liquid asset and enterprise-wide capital standards. Specifically, Ginnie Mae has raised the net worth requirement for participating in its Single Family program from $1 million to $2.5 million; for participating in its Multifamily program from $500,000 to $1 million; and in the program in which MBS are backed by reverse mortgages from $1 million to $5 million. For participating in its new Manufactured Housing program, Ginnie Mae established a net worth requirement of $10 million. In addition to these new net worth requirements, all Ginnie Mae Issuers are required to maintain least of 20 percent of their net worth in liquid assets.

Of course, the primary risk management objective *after* an Issuer meets the eligibility requirements and is approved to join the program is to ensure that it has the financial capacity to meet its obligations to investors. To accomplish this, Ginnie Mae regularly evaluates the financial statements of each Issuer to confirm its net worth, liquid assets, and capital; conducts field reviews to assess compliance with program requirements; verifies the insurance status of its collateral; and monitors the delinquency levels of its Issuers' portfolios.

Risk management practices and cost modeling procedures have been improved by increasing the staffing resources devoted to Issuer oversight, relationship management, and econometric modeling.

Ginnie Mae continues to enhance its risk management practices and cost modeling procedures. Cutting-edge technology tools – a corporate-watch program and an issuer scorecard – aimed at better tracking, analyzing, and scoring counter-party risk are near implementation. The corporate-watch program will allow Ginnie Mae to aggregate financial exposure, risk ratings, and financial data across all Issuers and their affiliates. The issuer scorecard will enable to Ginnie Mae to evaluate and compare Issuers with one another, scoring their performance relative to their peers and to established benchmarks. The increase in personnel funds included in the recently enacted 2012 appropriations bill will support these enhancements.

More comprehensive data on FHA loans and customized economic scenarios have been added to Ginnie Mae's cost modeling methods. It has also incorporated additional loan-level detail such as streamline-refinance status on loans through data-sharing agreements with the FHA. Ginnie Mae plans to further enhance its risk management practices and cost modeling to ensure the most accurate results. Planned enhancements in risk management practices include developing options to better manage and dispose of the assets of defaulted Issuers, designing new methodologies for assessing the risk of mortgage banks and non-regulated entities, and improving operational risk by strengthening the oversight of external vendors. With respect to cost modeling Ginnie Mae is implementing a plan to develop econometric models which more accurately forecast issuer default risks and their associated costs through different economic environments. Ginnie Mae plans to incorporate sensitivity analysis to identify which cash flow assumptions will have the greatest impact on its cost modeling, and to add more sophisticated economic scenarios that test multiple variables simultaneously.

The effectiveness of Ginnie Mae's efforts was affirmed when Ginnie Mae recently engaged McKinsey & Company to assess its risk management practices. McKinsey & Company concluded that Ginnie Mae's risk management practices and infrastructure should, in all but the most extreme circumstances, protect it from significant financial and operational events. Indeed, given Ginnie Mae's positive performance during the current crisis, while we will pursue additional improvements as described above, I am confident that Ginnie Mae has the risk management practices and cost modeling procedures in place to adequately protect tax payers.

The Way Forward

Mr. Chairman and Ranking Member Frank, as is clear from the review by the independent actuaries of FHA's Mutual Mortgage Insurance Fund, FHA is at a critical juncture. It continues to play a crucial role in our housing markets – perhaps more so than at any point in its history. But having played such an outsized role in a distressed economy, and without appropriate risk management and policy controls at the outset of the housing crisis, FHA has been forced to deal with unprecedented stresses to its insurance Fund.

We must continue to take actions that vigorously protect the Fund while assisting the market to fully recover. The way forward is clear. First, FHA must continue to extend credit to responsible borrowers who are capable of meeting their obligations while carefully stepping back its market share, a process that has begun already. Second, borrowers facing difficulties in meeting their obligations need to be provided with a range of potential solutions, and afforded appropriate assistance by their servicers. And

FHA must possess robust and comprehensive lender oversight and counterparty risk management capabilities commensurate with the insurance services it provides.

The actuarial report demonstrates that the sweeping changes made since the Administration took office in 2009 have dramatically improved the prospects for the long-term health of the MMI Fund, despite the virtually unprecedented challenges facing the FHA as a result of the housing crisis. And the vigilance and attention this Administration has shown to protecting taxpayers through the effective management of FHA will continue aggressively.

FHA continues to evaluate the policy options we have available so that we can implement appropriate measures to ensure even better performance of the Fund going forward. These potential policy options would build off of the foundation of reforms FHA has already put in place and some will require Congressional support. The five primary areas of focus for our actions are:

1. Premium increases: FHA is constantly evaluating the appropriate level of premiums given the potential risks to the MMI Fund, and any action regarding premiums will be considered in the context of balancing access to credit in today's economic environment with the need for added revenue generation to protect the Fund. This is a delicate balance, but we know we must first and foremost protect the Fund's resources so that its programs remain continually available.

2. Lender enforcement: A final rule to be published in the very near future outlines requirements related to indemnification by lenders participating in the Lender Insurance (LI) Program for loans that were improperly originated, or for which fraud or misrepresentation were involved. This final rule will permit FHA to improve its oversight of LI lenders and better protect its insurance Funds from the adverse effects of non-compliant loans. FHA has also sought via legislation expanded indemnification capabilities that would permit the Department to require indemnification by all lenders for loans that were improperly originated, not just those participating in the Lender Insurance Program. This authority would hold all FHA-approved standards to the same level of accountability and ensure that HUD has the ability to avoid or recover losses for non-compliant loans. Additionally, FHA has sought and would benefit from broader lender termination authority to more effectively target lender terminations based upon the risks presented by individual lenders. Such authorities would significantly enhance FHA's ability to hold lenders accountable for their underwriting of FHA loans and compliance with FHA requirements.

3. Loss mitigation: FHA is assessing further loss mitigation strategies, including potential changes to our partial payment of claim process as well as ensuring that the streamline refinance tool is being used as widely as appropriate.

4. Requirements for borrowers: While FHA will look carefully at any potential problem areas with regard to borrower credit quality and corresponding loan performance the Department

generally believes that existing requirements maintain appropriate standards to adequately protect the Fund. FHA is keenly aware of the need to balance its role in helping to facilitate the recovery of the housing market with appropriate management of risk to the MMI Fund. Moreover, further tightening of credit and down-payment requirements for future borrowers will not significantly impact FHA's financial resources and could deny access to mortgage financing for responsible borrowers, contrary to FHA's mission. FHA has already made substantial changes with regard to borrower qualification requirements under this Administration. Indeed, a final rule will soon be published that outlines changes to FHA's requirements regarding seller concessions. Allowable seller concessions will be reduced and allowed never to exceed actual closing costs. These changes will accord with industry norms regarding seller concessions and better protect the MMI Fund from risks associated with inflated appraisal values.

5. REO and pre-REO recovery: Through the Mortgage Acquisition and Disposition Initiative (601 Notes Sales) and various pilot opportunities resulting from the RFI process initiated in conjunction with FHFA and Treasury, FHA hopes to implement successful strategies to increase REO recovery rates, thereby limiting losses to the MMI Fund associated with HUD's REO property inventory.

Mr. Chairman, as the annual report to Congress shows, FHA's financial condition, while still facing risks that must be addressed, is remarkably resilient in the wake of the extraordinary turmoil in the housing market. Amid nearly unprecedented economic conditions that have devastated other institutions, FHA continues to provide a critical source of mortgage capital to responsible families who are ready for homeownership, in addition to bolstering a still-fragile housing market. And thanks to this Administration's reforms, combined with the important steps that lie ahead to further strengthen the status of the MMI Fund and reduce the footprint of FHA, we are working to ensure that FHA will continue to perform its historic mission while maintaining its responsibility to the American taxpayer.

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

United States Government Accountability Office

GAO

Testimony
Before the Committee on Financial Services, House of Representatives

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FEDERAL HOUSING ADMINISTRATION

Risks to the Mutual Mortgage Insurance Fund and the Agency's Operations

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

U.S. Government Accountability Office
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ACCOUNTABILITY * INTEGRITY * RELIABILITY

GAO-12-277T

GAO Accountability * Integrity * Reliability

Highlights

Highlights of GAO-12-277T, a testimony before the Committee on Financial Services, House of Representatives

Why GAO Did This Study

The Federal Housing Administration (FHA) has helped millions purchase homes by insuring private lenders against losses from defaults on single-family mortgages. In recent years, FHA has experienced a dramatic increase in its market role due, in part, to the contraction of other mortgage market segments. The increased reliance on FHA mortgage insurance highlights the need for FHA to ensure that it has the proper controls in place to minimize financial risks while meeting the housing needs of borrowers.

This statement discusses (1) changes in the financial condition of FHA's fund used to insure mortgages—the Mutual Mortgage Insurance Fund (Fund)—and the budgetary implications of these changes; (2) how FHA evaluates the financial condition of the Fund; and (3) steps FHA has taken to assess and manage risks.

This statement is drawn from a recent report on FHA's oversight capacity (GAO-12-15) as well as a report issued in September 2010 on the financial condition of the Fund (GAO-10-827R). GAO also obtained updated information on the status of the Fund from the recently issued actuarial report on the Fund.

What GAO Recommends

GAO previously made recommendations on modeling the Fund's financial condition, risk assessments, and human capital. FHA agreed with these recommendations and told GAO they have efforts underway to implement them.

View GAO-12-277T. For more information, contact Mathew J. Scirè at (202) 512-8678 or sciremj@gao.gov.

December 1, 2011

FEDERAL HOUSING ADMINISTRATION

Risks to the Mutual Mortgage Insurance Fund and the Agency's Operations

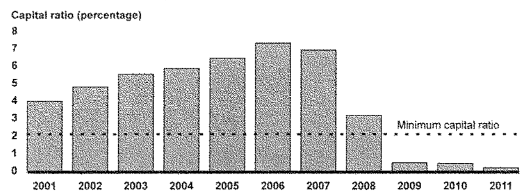
What GAO Found

For the third consecutive year, FHA reported that the Fund's capital ratio (the ratio of economic value to insurance-in-force) has not met the 2 percent statutory minimum (see below). FHA cites declines in the Fund's economic value due to higher-than-expected defaults, claims, and losses. At the same time, the other component of the ratio, FHA's insurance-in-force, has grown rapidly. The Fund's condition also worsened from a budgetary perspective, with balances in the Fund's capital reserve account reaching new lows. If the account were depleted, FHA would require more funds to help cover costs on insurance issued to date.

FHA enhanced methods for assessing the Fund's financial condition but has not yet addressed GAO's 2010 recommendation for improving the reliability of its estimates. It relies on a single economic forecast, which does not fully account for variability in future house prices and interest rates. An approach that would simulate hundreds of economic paths for house prices and interest rates would improve the reliability of its capital ratio estimates.

FHA has taken or plans a number of steps to better assess and manage risk. It created a risk office in 2010 and hired a consultant to recommend best practices. FHA plans to charter committees to evaluate risks at enterprise-wide and programmatic levels. It began a quality control initiative in the Office of Single Family Housing, in which program and field offices assess and report on risks. FHA also enhanced lender and appraiser reviews. While FHA's consultant recommended integrating risk assessments, the quality control and risk office activities currently remain separate efforts. Also, the Office of Single Family Housing has not annually updated assessments since 2009 as required. Without integrated and updated risk assessments that identify emerging risks, FHA lacks assurance it has identified all its risks. Further, human capital presents challenges. FHA has not created a systematic workforce plan to identify critical skills and skill gaps. Such a plan will be needed because high percentages of staff are eligible to retire soon. Without a workforce planning process that includes succession planning, FHA's ability to systematically identify workforce needs is limited.

Estimate of the Fund's Capital Ratio, 2001-2011



Source: GAO analysis of FHA data.

Chairman Bachus, Ranking Member Frank, 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). As you know, FHA has helped millions of families purchase homes through its single-family mortgage insurance programs and insures almost all of its single-family mortgages under the Fund.

FHA reported in November 2011 that for the third consecutive year, the Fund was not meeting the statutory 2 percent capital reserve requirement, as measured by the Fund's estimated capital ratio—that is, the Fund's economic value divided by the insurance-in-force. 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 could require additional funds to help cover its costs on insurance issued to date. The increased reliance on FHA mortgage insurance highlights the need for FHA to ensure that it has the proper controls in place to minimize financial risks while meeting the housing needs of borrowers.

My statement today is based on a September 2010 report about FHA's financial condition and a report issued in November of this year about the agency's risk assessment and human capital management.[1] Specifically, I will discuss (1) how estimates of the Fund's capital ratio 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, and (3) steps FHA has taken to manage and assess risks. I also will briefly discuss our report on the risks faced by the Government National Mortgage Association (Ginnie Mae), which was released today.[2]

To do this work, we analyzed actuarial reviews of the Fund and federal budget documents, and interviewed FHA officials, staff from FHA's

[1]See GAO, *Mortgage Financing: Opportunities to Enhance Management and Oversight of FHA's Financial Condition*, GAO-10-827R (Washington, D.C.: Sept. 14, 2010) and GAO, *Federal Housing Administration: Improvements Needed in Risk Assessment and Human Capital Management*, GAO-12-15 (Washington, D.C.: Nov. 7, 2011).

[2]GAO, *Ginnie Mae: Risk Management and Cost Modeling Require Continuing Attention*, GAO-12-49 (Washington, D.C.: Nov. 14, 2011).

actuarial review contractor, and selected housing market researchers. We also analyzed data on FHA's business volume, market share, workload, and staff and contractor resources. We reviewed documentation on the proposed structure and functions of FHA's Office of Risk Management and Regulatory Affairs and the Office of Single Family Housing's internal quality control initiative. Finally, we reviewed changes to FHA guidance that address risks associated with lenders and appraisers and documentation related to workforce and succession planning. Our study of Ginnie Mae assessed operational risks and financial exposure. We reported on Ginnie Mae volume and market share, reviewed guidance and Ginnie Mae's credit subsidy calculations and estimation model, and interviewed agency officials and others. The reports include a detailed description of our scope and methodology.

The work on which this statement was based was performed from September 2009 to November 2011 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.

Background

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 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.[3] 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—reestimates—on the basis of information about actual performance and estimated changes in future loan performance. FCRA recognized the difficulty of

[3]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.

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 Omnibus Budget Reconciliation Act of 1990 required the Secretary of the Department of Housing and Urban Development (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, which also requires that the Secretary of HUD annually report to Congress on the results of the review.

Federal agencies face a number of risks. In the case of agencies with loan guarantee or insurance programs, they can face credit risks that include borrower default risk, which arises as borrowers become unable to make payments on insured mortgages. Agencies with these programs also face counterparty risk. That is, an agency may suffer losses due to weaknesses or uncertainties in the work of its counterparties—in this example, lenders and appraisers. And all agencies face operational risks, the risk of loss resulting from inadequate or failed internal processes or people (in terms of staff numbers, training, and skills), or external events. For this statement, we focus on operational risks related to FHA's staffing and contractor capacity to process increasing workloads.

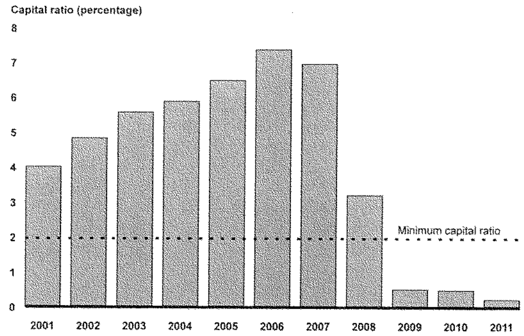
The Fund's Financial Condition Continues to Worsen, Increasing the Possibility That FHA Will Require Additional Funds

The Fund's capital ratio dropped sharply in 2008 and fell below the statutory minimum in 2009, when 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).[5] According to annual actuarial reviews of the Fund, the capital ratio fell from about 7 percent in 2006 to 3 percent in 2008 and 0.5 percent in 2009 (see fig. 1). For 2010 and 2011, the ratios were 0.5 and 0.24 percent, respectively.

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

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

Figure 1: Estimates of the Fund's Capital Ratio, 2001–2011



Source: GAO analysis of FHA data.

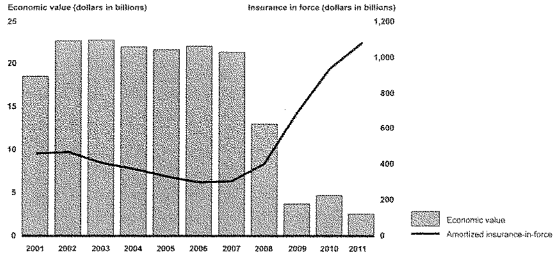
In its recent report to Congress, HUD cited several reasons for the declines from 2010 to 2011. These included

- Continuing declines in home prices. Forecasts for the 2010 actuarial study predicted house price declines of 2.8 percent before bottoming in the middle of 2011. This year's forecasts—dated July 2011—predicted negative growth of 5.6 percent for FHA's single-family portfolio in 2011. Higher-than-expected declines in house values contributed to both higher defaults and claims and higher loss-on-claim than anticipated last year.
- More loans, particularly from the housing bubble years of 2006-2008 were in serious delinquency, and a significant percentage had been there for more than one year. Claims become the most likely outcome for extended delinquency loans, many of which are in foreclosure.
- For the first time, the actuarial calculations built in factors recognizing the elevated re-default potential from the increased number of active loans with a previous serious delinquency (3 months or more).

- The independent actuaries also made a decision to treat foreclosure actions likely affected by so called robosigning problems as expected claims in 2012.[6]

In reviewing the components of the capital ratio, the combination of a relatively stable economic value (numerator of the ratio) and a declining insurance-in-force (denominator) over much of the decade increased the capital ratio. However, since 2008, the economic value has fallen as the insurance-in-force has risen, dramatically lowering the capital ratio (see fig. 2).

Figure 2: Estimates of the Fund's Economic Value and Insurance-in-force, 2001–2011



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 was a negative subsidy program (that is, estimated cash inflows exceeded expected cash outflows). On the basis of these estimates, FHA accumulated substantial balances in a budgetary account known as the capital reserve account, which holds reserves in excess of those needed for estimated credit subsidy costs and helps cover unanticipated

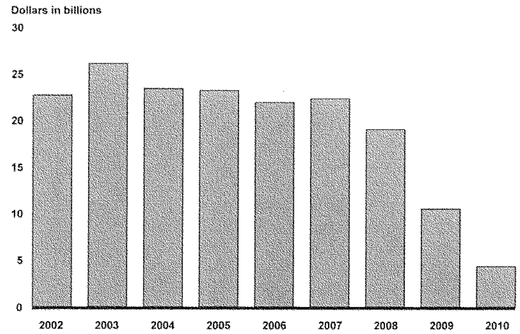
[6]Robosigning refers to mortgage servicers' practice of having a small number of employees sign a large number of affidavits and other legal documents that mortgage companies subsequently submitted to courts and other public authorities to execute foreclosures. For more information, see GAO, *Mortgage Foreclosures: Documentation Problems Reveal Need for Ongoing Regulatory Oversight*, GAO-11-433 (Washington, D.C.: May 2, 2011).

increases in those costs such as higher-than-expected claims. Reserves needed to cover estimated subsidy costs are held in the Fund's financing account.[7]

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 $4.4 billion by the end of 2010 (see fig. 3). 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. FHA's latest annual report to Congress raises the possibility that if house prices decline in 2012, the expected future losses on the current, outstanding portfolio could exceed current capital resources. These would be offset by the expected net receipts from the new 2012 cohort of loans. But, according to HUD, if house prices were to decline in 2012 by an amount rivaling that of 2011, these new loans would not be expected to generate sufficient net receipts to offset any potential decline in value of the current outstanding portfolio, which could necessitate assistance from the Department of the Treasury (Treasury). Under one stress scenario in which house prices decline by 13.7 percent in 2011, rather than the 5.6 percent assumed in the baseline scenario, and house prices decline another 1.3 percent in 2012, HUD estimates that it may require $13 billion in assistance from Treasury to ensure the financing account had sufficient loss reserves.

[7]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 3: End-of-Year Balances in the Fund's Capital Reserve Account, 2002–2010



Source: GAO analysis of federal budget data.

FHA's Current Methodology for Assessing the Fund's Condition Does Not Fully Account for Future Economic Volatility

As we reported in September 2010, FHA and its actuarial review contractor enhanced their methods for assessing the Fund's financial condition but still were addressing other methodological issues that could affect the reliability of estimates of the capital ratio. 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 loan-to-value ratios and borrower credit scores) and key economic variables (such as house prices and interest rates).[8] FHA and its contractor have enhanced these models in recent years, by incorporating additional variables 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, in 2003 the actuarial reviews began to analyze the impact of

[8]The loan-to-value ratio is the ratio of the amount of the mortgage loan to the value of the home.

more pessimistic economic scenarios—for example, nationwide declines in home prices—than they did previously.[9]

However, the current methodology is significantly limited by its reliance on a single economic forecast to produce the estimate of the capital ratio that is used to determine if 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 November 2003 report, the Congressional Budget Office concluded that FHA could project the Fund's cash flows more accurately by using an approach (stochastic modeling) that involves running simulations of hundreds of different economic paths to produce a distribution of capital ratio estimates.[10]

Given the uncertainty that always surrounds estimates of future economic activity, the report we issued last year recommended 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. However, the most recent annual report does not include an estimate of the Fund's capital ratio using this technique. In response to our 2010 report, 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. But, these officials said that the model would be used to examine the implications of extreme economic scenarios on the Fund and decisions about using the model to estimate the Fund's capital ratio had not been made.

[9]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).

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

FHA Has Taken Steps to Address Risks, but Has Yet to Implement a Comprehensive Risk-Assessment Strategy

FHA faces risks resulting from its operations. FHA's loan volume grew significantly from 2006 to 2010. In 2006, FHA insured almost half a million loans, totaling $70 billion in mortgage insurance. By 2010, it insured 1.7 million loans, or about $319 billion in mortgage insurance. During the same time period, FHA's single-family staff increased 8 percent, from 932 employees in 2006 to 1,011 employees in 2010, while increases in key workload areas often surpassed 100 percent:

- Staff in the homeownership centers' Processing and Underwriting Division grew at a slower rate (22 percent) than key workload items, particularly volume-driven loan reviews (which increased by more than 100 percent).
- Increases in contractor staff and workload related to management of foreclosed or real estate-owned properties were substantial, but noncontractor staff levels increased at more modest levels.
- Loss mitigation actions more than doubled from 2006 to 2010, while loss mitigation staff levels remained relatively constant.[11]

Although FHA Worked to Address Credit and Operational Risk, It Has Not Yet Put a Comprehensive Strategy in Place

Although FHA has taken steps to assess credit and operational risks facing its single-family insurance programs, its current risk-assessment strategy is not comprehensive because it is not integrated across the agency and lacks annual assessments and mechanisms to anticipate changing conditions. To address credit risk and help improve the financial condition of the Fund (which is supported by borrower premiums), FHA raised premiums and made or proposed policy or underwriting changes. For example, in April 2011 FHA increased its annual insurance premiums from 0.85 percent to 1.10 percent for borrowers with 30-year loans with initial loan-to-value ratios of 95 percent or less and from 0.90 percent to 1.15 percent for borrowers with 30-year loans with initial loan-to-value ratios greater than 95 percent. Additionally, FHA increased down-payment requirements for borrowers with lower credit scores. FHA also has proposed reducing allowable seller contributions at closing, thereby helping to ensure that buyers put more of their own funds into the home purchase. In addition, FHA is in the process of revising its mortgage scorecard algorithm, to recognize the effect of various risk elements not

[11]Loss mitigation actions seek to minimize losses from potential foreclosures by finding alternatives to foreclosure and helping homeowners retain their homes, if possible.

currently discerned by the scorecard and determine what cases warrant manual underwriting.[12] According to FHA, these revisions are in the early stages, and no completion date has been set.

To address operational risks and improve its risk-assessment strategy, in 2010 FHA received congressional approval to establish the Office of Risk Management and Regulatory Affairs and create the position of Deputy Assistant Secretary for Risk Management and Regulatory Affairs, which reports directly to the Assistant Secretary for Housing-FHA Commissioner. To provide assistance to the Office of Risk Management (one of the offices within the Office of Risk Management and Regulatory Affairs) in developing a risk-management strategy and organizational structure and establishing risk-management policies and processes, FHA hired a consultant to produce a comprehensive report and recommend best practices for its operation.[13] According to FHA officials, FHA plans to adopt the consultant's recommendation to establish an enterprise risk committee to address overall risk to the organization and a second tier of committees to address program and operational risks. In addition, in 2009 the Office of Single Family Housing implemented an internal quality control initiative at headquarters and the four homeownership centers. For the areas identified as high-risk, headquarters and the homeownership center divisions developed plans to document control objectives and established a monitoring strategy in which each homeownership center submits quarterly reports to headquarters on the effectiveness of the controls, including the status of any mitigation efforts.

However, FHA's risk-assessment strategy raises several issues. First, FHA's current risk-assessment strategy is not comprehensive because it is not integrated throughout the organization. While the consultant recommended that FHA integrate risk assessment and reporting throughout the organization, currently Single Family Housing's quality control activities and the Office of Risk Management's activities remain separate efforts. FHA officials noted that until the Office of Risk Management set up a governance process, the integration suggested by

[12]The purpose of the algorithm is to objectively measure the borrower's risk of default quickly and efficiently by examining the data the borrower provides on the loan application and the borrower's credit score.

[13]McKinsey & Company, *Building the ORM Organization, Close-out Materials*, a report prepared at the request of the Department of Housing and Urban Development, December 2010.

the consultant would not be possible. In the meantime, they stated that every effort was being made to help ensure that the Office of Risk Management's activities complemented program office activities. Second, contrary to HUD guidance, Single Family Housing has not conducted an annual, systematic review of risks to its program and administrative functions. According to an official in the Office of Single Family Housing, although management intended to conduct an annual assessment, the dates slipped because of changes in senior leadership in Single Family Housing and few staff were available to perform assessments (because of attrition and increased workload). Finally, Single Family Housing's current risk-assessment efforts do not include procedures for anticipating potential risks presented by changing conditions. The consultant's report proposes a reporting process and templates for identifying emerging risks and provides specific examples. Office of Risk Management officials told us that once they are operational the risk committees eventually would determine the exact design and content of the reports and templates.

Moreover, implementation and integration of the new risk-assessment strategy and planned tools has been slow because of delays in defining the Office of Risk Management's authority, difficulty filling new staff positions in the Office of Risk Management, and changes in FHA leadership.

All these factors limit FHA's effectiveness in identifying, planning for, and addressing risk. More specifically, without an integrated risk-assessment strategy, certain risks may not be fully addressed at the operational level in a way that minimizes risk to the insurance programs; without annual reassessments of its risks, Single Family Housing lacks assurance that its quality control efforts address all its risks; and without ongoing mechanisms in place to anticipate and address new or emerging risks, FHA lacks a systematic approach to help the agency identify, analyze, and formulate timely plans to respond most effectively to changed conditions and risks. Therefore, we recommended that FHA (1) integrate the internal quality control initiative of the Office of Single Family Housing into the operational risk processes of the Office of Risk Management, (2) conduct an annual risk assessment, and (3) establish ongoing mechanisms—such as use of the report templates from the 2010 consultant's report—to anticipate and address risks that might be caused by changing conditions. FHA agreed with the recommendations and stated that it either was working toward achieving the recommendations or had plans to do so in the very near future. For example, FHA said it would leverage or integrate existing risk management efforts as soon as the Office of Risk Management's final governance structure and risk management strategies were in place. The agency also stated that the Office of Risk Management would conduct an annual risk assessment as a component of its overall risk management strategy. It stressed that ongoing mechanisms to anticipate and address risks related to changing conditions would be part of the office's strategy.

FHA Has Taken Steps to Address Counterparty Risks, but Continues to Face Human Capital Challenges

With growth in loan volume, the number of lenders and appraisers (or counterparties) participating in FHA's single-family programs also has grown. The total number of FHA-approved lenders increased 24 percent, from 10,370 in 2006 to 12,844 in 2010. The number of FHA-approved appraisers increased approximately 67 percent from 33,553 in 2006 to 56,192 in 2010.

However, FHA has made recent changes to address risks posed by its lenders and appraisers. For example, on May 20, 2010, FHA stopped approving new loan correspondents.[14] As of January 1, 2011, existing loan correspondents could no longer participate in FHA programs. Former loan correspondents now can participate only as third-party originators through sponsorship by FHA-approved lenders. As a result, as of September 2011, FHA had almost 3,700 approved lenders. Furthermore, the agency has increased the net worth requirement for approved lenders. On May 20, 2011, FHA increased the requirement for existing lenders to $1 million, except for lenders classified as small under the Small Business Administration's size standards (their requirement increased to $500,000). As of May 20, 2013, FHA will require a net worth of $1 million for all lenders, plus 1 percent of the total loan volume in excess of $25 million, to a maximum required net worth of $2.5 million.[15] To help ensure that lenders and appraisers follow its policies and procedures, FHA also has enhanced the criteria used to select loans for technical reviews. Specifically, since May 3, 2010, the agency has considered high-risk loan or borrower characteristics, such as certain

[14]Loan correspondents were lenders that originated FHA-insured loans—meaning that they could accept mortgage applications, obtain employment verifications and credit histories on applicants, order appraisals, and perform other tasks that precede the loan underwriting process—but did not have direct endorsement authority. Direct endorsement authority is the authority to underwrite loans and determine their eligibility for FHA mortgage insurance without HUD's prior review.

[15]Loan volume is defined as FHA single-family insured mortgages originated, underwritten, purchased, or serviced during the prior fiscal year.

types of refinanced loans and loans to borrowers with low credit scores. Additionally, FHA increased the number of risk factors used to target lenders for review. FHA also has revised its approach for overseeing appraisers.

FHA has addressed staffing and training needs and succession planning to some extent, but it lacks plans that strategically address future workforce needs, including replacing retiring staff. Although workforce planning practices used by leading organizations include defining critical skills and skill gaps, FHA's current approach does not have mechanisms for doing so. FHA previously had a multiyear workforce plan that identified the critical competencies; analyzed skills and competencies, including gaps; and proposed comprehensive strategies to address these gaps, but has not created another such plan.[16] Instead, FHA has relied on occasional Resource Estimation and Allocation Process studies and annual managerial assessments of staffing and training needs.[17]

FHA also currently does not have a succession plan, although a HUD plan for 2006–2009 identified mission-critical positions, analyzed existing staff competencies, assessed the number of retirement-eligible employees, and determined the probability of near-term retirements.[18] Succession planning is particularly important because almost 50 percent of Single Family Housing headquarters staff are eligible to retire in the next 3 years. The percentage of staff eligible to retire at the homeownership centers is even higher—63 percent.

While FHA has taken some steps to address succession planning, they have been limited. FHA implemented two initiatives focused on succession planning. The first, begun in 2010, was intended to help ensure that, at any given time, at least two additional supervisors, managers, or executives could perform the work of each supervisor, manager, or executive. However, this does not apply to staff positions

[16]Department of Housing and Urban Development, *Strategic Workforce Plan, FY04 to FY08, Office of Housing,* (Washington, D.C.: July 2004).

[17]Resource Estimation and Allocation Process studies establish a staffing baseline for budget formulation and execution, strategic planning, organizational and management analyses, and ongoing management of staff resources.

[18]Department of Housing and Urban Development, *Succession Management Plan, Fiscal Year 2006-2009,* (Washington, D.C.: September 2006).

beyond management. The second initiative also began in 2010. Its goal is to train and develop staff. Neither initiative assesses the number of retirement-eligible employees in critical positions as required by HUD guidance. According to FHA officials, as resources have dwindled, they have considered all their positions to be critical.

According to FHA officials, plans to update their workforce and succession plans were suspended. In 2007–2009, FHA had a workforce planning process designed to identify critical skill gaps and a strategy for addressing these gaps. According to the officials, HUD told FHA to stop this initiative in 2009 because HUD was going to implement a workforce planning process for the entire department. However, the effort never came to fruition because of funding shortages. Without a more comprehensive workforce planning process that includes succession planning, FHA's ability to systematically identify the workforce needed for the future and plan for upcoming retirements is limited. Therefore, we recommended that FHA develop workforce and succession plans for the Office of Single Family Housing. FHA agreed, stating that it would develop a formal workforce plan and had efforts underway to develop a succession plan.

Ginnie Mae's Risk Management and Cost Modeling Require Continuing Attention

We released a report today about Ginnie Mae, which has experienced a substantial increase in the volume of its business since 2007 as the volume of federally insured or guaranteed mortgages increased. Ginnie Mae is a wholly owned government corporation in HUD, which guarantees the timely payment of principal and interest on mortgage-backed securities (MBS) backed by pools of federally insured or guaranteed mortgage loans, such as FHA loans. As of 2010, Ginnie Mae guaranteed more than $1 trillion in outstanding MBS composed primarily of FHA-insured mortgages. The growth in outstanding Ginnie Mae-guaranteed MBS resulted in an increased financial exposure for the federal government. Nonetheless, Ginnie Mae's revenues exceeded its costs, and it has accumulated a capital reserve of about $14.6 billion.

Ginnie Mae has taken steps to better manage operational and counterparty risks and has several initiatives planned or underway. The operational risks the agency may face include limited staff, substantial reliance on contractors, and the need for modernized information systems. Ginnie Mae plans to increase its staff levels, complete a reorganization, and implement recommendations related to contracting. For Ginnie Mae, counterparty risk is the risk that issuers of Ginnie Mae MBS fail to provide investors with monthly principal and interest payments. To manage its counterparty risk, Ginnie Mae has processes in place to oversee MBS issuers that include approval, monitoring, and enforcement and has revised its approval and monitoring procedures. For example, in 2010 Ginnie Mae increased the minimum net worth requirement for issuers of Ginnie Mae-guaranteed MBS to $2.5 million. But, planned initiatives to enhance its risk-management processes for issuers, including its tracking and reporting systems, have not been fully implemented. It will be important for Ginnie Mae to complete its initiatives related to operational and counterparty risk as soon as practicable.

In developing inputs and procedures for the model used to forecast costs and revenues, Ginnie Mae did not consider certain practices identified in Federal Accounting Standards Advisory Board (FASAB) guidance for preparing cost estimates of federal credit programs. Ginnie Mae has not developed estimates based on the best available data, performed sensitivity analyses to determine which assumptions have the greatest impact on the model, or documented why it used management assumptions rather than available data. By not fully implementing practices in FASAB guidance that GAO believes represent sound internal controls for models, Ginnie Mae's model may not use critical data that could affect the agency's ability to provide well-informed budgetary cost estimates and financial statements. This may limit Ginnie Mae's ability to accurately report to Congress the extent to which its programs represent a financial exposure to the government.

We recommended that the Secretary of Housing and Urban Development direct Ginnie Mae to take steps to ensure its model more closely follows certain practices identified in Federal Accounting Standards Advisory Board guidance for estimating subsidy costs of credit programs. More specifically, Ginnie Mae should (1) assess and document that it is using the best available data in its model and most appropriate modeling approach, (2) conduct and document sensitivity analyses to determine which cash flow assumptions have the greatest impact on the model, (3) document how management assumptions are determined, such as those for issuer defaults and mortgage buyout rates, and (4) assess the extent to which management assumptions, such as those for issuer defaults and mortgage buyout rates, can be replaced with quantitative estimates. The President of Ginnie Mae wrote that Ginnie Mae is working towards implementing our recommendation for conducting sensitivity analyses relating to issuer risk and behavior, but neither agreed nor disagreed with our other specific recommendations. In addition, Ginnie Mae agreed with our observation about the importance of completing ongoing and planned initiatives for enhancing its risk-management processes, as soon as practicable, to improve operations.

Mr. Chairman, Ranking Member Frank, 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

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STATEMENT OF PATRICK SINKS ON BEHALF OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA BEFORE THE HOUSE FINANCIAL SERVICES COMMITTEE
December 1, 2011

I am Patrick Sinks, President and COO of Mortgage Guaranty Insurance Corporation, testifying on behalf of the Mortgage Insurance Companies of America (MICA), the trade association representing the private mortgage insurance industry. I am pleased to be here today to take a comprehensive look at the financial situation of the Federal Housing Administration (FHA) and to offer suggestions on ways to improve its financial security and overall operation.

The mortgage insurance (MI) industry is similarly situated to FHA in that we insure loans with less than a 20% down payment, so we are particularly well suited to help Congress determine the best way to maintain FHA's viability. Importantly, MICA has been analyzing and commenting on the financial health of FHA for over 20 years. MICA advocated for and supported the financial reforms to FHA that were enacted in the National Affordable Housing Act of 1990 when most other sectors of the mortgage market did not. That Act was passed because FHA was in unprecedented stress at the time and policy makers feared taxpayers would be forced to bailout FHA. In fact it was that Act that, for the first time, required FHA to maintain a minimum capital ratio, which was set at 2%. It was also that Act that mandated the yearly actuarial report that is the subject of this hearing today. It would appear as if we are at a similar crossroad today as FHA's capital ratio is getting perilously close to being in the negative.

The private mortgage insurance industry believes the FHA has an important role to play in the mortgage markets as a supplement to private capital sources. While both entities provide first loss credit risk protection on low down payment mortgages, FHA is a government program while MI is private capital put at risk. For over fifty years the private mortgage insurance industry has supplied credit enhancement to borrowers seeking their first home at the same time as the FHA has provided its credit enhancement to other first-time borrowers.

While there has always been some overlap between the customers served by private mortgage insurers and FHA, we believe that it is important that there be both private capital made available through mortgage insurers for low down payment borrowers as well as government-backed capital made available through FHA for those borrowers who, because of income, credit or other characteristics require the additional support that only a government guarantee provides. We believe that both entities have knowledge and strengths that can be employed separately and, perhaps, together to serve first time homebuyers. FHA, as a government program, must not be employed either intentionally or unintentionally as a means of blocking the re-entry of private capital to the mortgage markets.

The FHA is a government program that serves a vital purpose and as such should be actuarially sound at all times. I hope my testimony helps you determine the best course of action to achieve that goal. In the testimony, I will do the following:

- Summarize the role private mortgage insurance plays in the market and then discuss the industry's regulatory structure.
- Summarize the differences between the way FHA and private mortgage insurers operate.
- Discuss why FHA now dominates the market.
- Provide the industry's insight into the recent actuarial study.
- Suggest some changes to FHA that could help increase its capital levels.

The Role of Private Mortgage Insurance

The private mortgage insurance industry has greatly expanded homeownership opportunities for Americans. Since the industry was founded in 1957 it has helped more than 25 million people buy homes with low down payments.

Because mortgage insurers have their own capital at risk and are in a first loss position if the loan goes to foreclosure, mortgage insurers' interests are aligned with those of the borrower, servicer and mortgage investor. This ensures better quality mortgages. Mortgage insurers act as a second set of eyes by reviewing the credit and collateral risks related to individual loans. This role protects both borrowers and investors by ensuring that the home is affordable at the time of purchase and importantly throughout the years of homeownership.

<u>The Regulatory Structure of MI</u>

MI is a regulated, counter-cyclical source of loan level protection provided for a mortgage loan, based on independent, objective underwriting criteria. This third-party credit enhancement expands mortgage credit availability, especially for loans with high loan-to-value ratios, because third-party capital is deployed to back this risk. This is particularly important under current market circumstances to ensure ongoing credit availability in this sector at a time when U.S. banks are under significant capital constraint that otherwise would limit their ability to make these loans.

It is for this reason that global regulators have repeatedly reviewed and, then, confirmed the value of properly-regulated and appropriately capitalized private mortgage insurance. In January of 2010,[1] the Joint Forum urged member nations to ensure that

[1] The Joint Forum, *Review of the Differentiated Nature and Scope of Financial Regulation - Key Issues and Recommendations,* (Jan. 8, 2010), *available at* http://www.bis.org/publ/joint24.pdf.

greater use of MI is part of their mortgage-reform efforts. The Joint Forum is an advisory committee comprised of global banking, securities and insurance regulators. In addition to urging greater reliance on MI, the Joint Forum paper described the need to ensure that capital credit and regulatory recognition is provided only when private MI is in fact well regulated and capitalized, noting the significant problems that result from reliance on products such as credit derivatives.

The Joint Forum's advisory work has since been advanced as a firm recommendation from the Financial Stability Board[2] (FSB), the governing body for all global financial regulators (including those in the U.S.). In its final paper detailing recommendations for mortgage underwriting, the FSB concludes that, "Mortgage insurance can be relevant for the reduction of uncertainty through risk selection and pricing, a prudent application which includes an in-depth assessment of mortgage insurance reliability. The recent crisis has shown how deceptive risk transfer mechanisms can be."[3]

Now, the FSB is proposing specific mortgage-underwriting standards to guide specific rules for residential finance.[4] MICA strongly supports the FSB's recommendations, which recommend reliance on private mortgage insurance subject to prudential regulation such as that governing the industry in the United States.

The backbone of the private mortgage insurance industry's ability to pay claims through this extreme down cycle in the mortgage market is its state-imposed reserve requirements. The reserve requirements were developed in a model MI act that was established by the National Association of Insurance Commissioners (NAIC) and is primarily enforced by the states where MI companies are domiciled. The requirements are specifically structured to address the long-term nature of MI risk. They enable the industry to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur normally throughout the cycle.

Mortgage insurers are required to keep three types of reserves, the most important of which is the contingency reserve. Fifty cents of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for a 10-year period. It ensures that significant reserves are accumulated during good times to handle claims under stress. The contingency reserves are directly comparable to the counter-cyclical capital bank regulators now know they need. Mortgage insurers are subject to similar mortgage default risk as banks but only mortgage insurers maintain capital counter-cyclically.

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[2] Financial Stability Board, *Thematic Review on Mortgage Underwriting and Origination Practices* (Mar. 17, 2011), *available at* http://www.financialstabilityboard.org/publications/r_110318a.pdf.
[3] Ibid, p. 25.
[4] Financial Stability Board, *FSB Principles For Sound Residential Mortgage Underwriting Practices* (Oct. 26, 2011), *available at* http://www.financialstabilityboard.org/publications/r_111026b.pdf.

Chart 1 demonstrates how the MI industry builds its capital base during good times to pay claims in bad times like those currently experienced by the housing market. The chart shows yearly industry losses paid as a percentage of premiums earned for each year from 1980 through 2010. It also shows the MI industry's risk to capital ratio for each year and the build-up of premiums available to pay claims over time. As can readily be seen, the fact that mortgage insurers are required to keep a portion of the premiums in a contingency reserve means that premiums available to pay claims increase during the good times so they can be paid out to cover the serious losses that occur during the bad times.

The other two reserves that mortgage insurers must maintain are case-basis loss reserves and unearned premium reserves. Case-basis loss reserves are established for losses on individual policies when the insurer is notified of defaults. Premiums received for the term of a policy are placed in unearned premium reserves. Each state establishes the method by which premiums are earned to match premiums with loss and exposure.

The history of the MI industry shows that we have paid our claims through all economic cycles. For example, in the early 1980s, the mortgage market had to cope with double-digit interest rates and inflation in a period of severe recession and, therefore, introduced many experimental adjustable-rate mortgages. As economic conditions deteriorated -- particularly in energy-oriented regions of the country -- defaults began to rise, resulting in numerous foreclosures. The MI industry paid more than $6 billion in claims to its policyholders during the 1980s. In the early 1990s, the MI industry paid more than $8 billion in claims primarily in California and the Northeast.

In the lead up to the present crisis, the industry early saw warnings of critical risk in the residential-mortgage market and tried through comments, meetings and other venues to get U.S. regulators to take urgent action to improve underwriting and securitization practices. Had the industry's warnings been heeded, while the crisis might still have occurred we believe it would not have proven to be the grave macroeconomic threat still blocking robust U.S. recovery. In its warnings to regulators starting in 2002, MICA repeatedly said that dangerous practices would "pollute the well" – that is, create risk for the prudently-underwritten loans backed by MI because problems on individual loans without these safeguards would drag the entire mortgage market into crisis.

However, private mortgage insurers have fared remarkably well despite severe stress. For example they have remained viable even as more diversified mortgage-finance operations like the GSEs failed. To date since the current crisis began, MIs have provided $28 billion in claims and receivables to the GSEs, reducing taxpayer losses by 15%.

But, as the crisis has dragged on, sound MI firms have been under growing stress due in part to the "pollute the well" problem. This has undermined the ability of several firms to write new business. Still, these firms are paying their claims in the "run-off" process stipulated by state regulators that ensures that an MI's commitments are honored even under acute stress. This – combined with the resilience the industry has shown despite the severity of the crisis – proves the soundness of the private MI business model and the stringency of state regulation.

Comparison of Private MI to FHA

While FHA and MI are similar in that they enable borrowers to buy homes with less than a 20% down payment there are some significant differences in the way the two models are structured which are discussed below.

- Private sector capital at risk – Private mortgage insurers have their own capital at risk on every loan they insure in the first dollar loss position. This means a mortgage insurer's claim payment stands in front of any loss of other parties to the transactions. As a result, MI acts as a bellwether for the risk to the borrower. Of course FHA is not private sector capital and, therefore, is not similarly situated.

- Coinsurance feature – An essential feature of private mortgage insurance is the concept of coinsurance on the part of all parties to the transaction. MI generally covers 20% to 30% of the loan amount. However, that percentage generally does not cover all of the losses that the parties to the mortgage transaction experience. FHA, on the other hand, insures 100% of the loan amount if the loan goes to foreclosure so that the loan originator lacks any meaningful risk of loss. Coinsurance is essential to ensure that all parties to the transaction have an alignment of interest which in turn results in better originations.

- Respond to market conditions – FHA has a "one size fits all" type of underwriting system which does not allow FHA to respond to the build–up or deflation of mortgage market bubbles. Mortgage insurers, on the other hand, have heavily invested in analytical and automated underwriting tools so that we make sure the loans we insure meet our independent underwriting criteria. Mortgage insurers are constantly monitoring the regional mortgage markets and altering their underwriting to ensure that the home is both affordable for the borrower at closing and sustainable over the life of the mortgage. If there is one thing the mortgage market has learned in recent years it is that sustainability is as important as affordability.

- Second Set of Eyes – Mortgage insurers have underwriting criteria independent of the lender or investor. MI companies provide a unique level of process oversight – sometime described as a second set of eyes – that can serve as an important check on third party errors, omissions and misrepresentation. FHA sets the underwriting criteria for the loans, but delegates the actual underwriting process to the lender. There is no review underwriting process.

- Appropriate Systems in Place – Over the last several years the HUD Inspector General and the General Accountability Office have enumerated various problems with FHA's underwriting and operating systems. Many of these problems have been addressed but others have been identified including problems arising with direct endorsement lenders. Because private capital is at risk, private mortgage insurers have the most current technology and can receive up-to-date information on their portfolios. This enables them to better understand trends in the market and set better underwriting criteria.

- Amount of down payment – The other characteristic that is different in today's market is the amount of a down payment that an FHA borrower must make as opposed to the down payment required by a mortgage insurer. FHA's minimum down payment requirement is set in law and is 3.5%. MICA's members make separate decisions on their down payment requirements and have the flexibility FHA does not have to make adjustments to reflect economic conditions. In today's market the lowest down payment requirement generally is 5%.

FHA Dominates the Market for Low Down Payment Loans

The federal government has dominated the mortgage market since the beginning of the crisis and FHA in particular has crowded out the primary source of purely private capital at risk in the mortgage market today – the private mortgage insurance industry. Private MI is a sector of the mortgage market that did not receive government assistance during the crisis and is still serving the market today. To illustrate FHA's dominance, Chart 2 compares the market share of FHA and private MI in the total mortgage market. Chart 3 shows their comparative market shares in just the low down payment/insured market. FHA's market share has increased dramatically since 2007, rising from 17% to 62% from 2007 through second quarter 2011.

Discussed below are the factors contributing to FHA's historic market share.

- FHA Loan Limits too High - FHA's loan limits are extremely high. For the first time in history, they are larger than Fannie Mae and Freddie Mac's limits. The floor for the FHA limits is particularly high and cuts significantly into private insurers' market. The lowest FHA limits in any area of the country is $271,050. However, the median existing house price in the country is $165,600 and in many areas considered to be high cost the area median house price is significantly lower than the FHA floor. For example, the California Association of Realtors reported that statewide the median existing single family house price in California in October was $278, 060 which is barely above the lowest FHA limit while in the Southern California counties of Riverside and San Bernadino the median house prices were $195,760 and $132,210 respectively.

- <u>100% insurance coverage</u> – As noted above, FHA provides 100% insurance coverage if loans default. Mortgage insurers, on the other hand, insure 20% to 30% of the loan amount which means that in this housing environment all parties to the transaction have skin in the game.

- <u>Lower Down Payment</u> – As noted above, by statute FHA's minimum down payment is 3.5%. While individual MIs set their own down payment, it is generally 5%.

- <u>Inadequate premium</u> – While FHA has made important strides recently to bring its premium in line with the risk it is taking, it needs to do more. Under the law FHA can charge an upfront premium of no more than 3 percent that can be financed as part of the mortgage amount. The annual premium can go no higher than 1.55% of the insured principle balance depending on the LTV. Presently the upfront premium is 1% and the annual premium varies between 1.15% and .25% depending on the LTV, loan's purpose and the term of the mortgage.

- <u>Fees on GSE loans</u> - Private MI is being priced out of the market because the Government Sponsored Enterprises (GSEs) are charging additional fees on top of the mortgage insurance premium. The vast majority of loans private mortgage insurers insure are sold to Fannie Mae and Freddie Mac. Fannie and Freddie have been charging delivery fees that primarily apply to low down payment borrowers and can go as high as 3.5% depending on the borrower's credit characteristics, loan-to-value ratio, mortgage product type and type of housing.

In fact, the HUD report to Congress notes that the FHA and private MIs do not play on a level playing field. HUD clarifies that conventional borrowers are put at a disadvantage to FHA borrowers because of the GSEs' loan level fees. The report notes that "even loans for which private mortgage insurance costs might be comparable or even lower than FHA prices, the delivery fees charged by Fannie Mae and Freddie Mac can make such loans inaccessible to homebuyers with limited wealth." It also notes that "Fannie Mae and Freddie Mac do not currently purchase loans with down payments of less than 5 percent."[5] While these facts benefit FHA today in that borrowers who would otherwise use private insurance move to the government program, it seriously impedes the redeployment of private capital in the mortgage markets and should be addressed from a public policy perspective.

Actuarial Study

The FY 2011 actuarial report for FHA's mutual mortgage insurance (MMI) fund raises key points which should be of concern to Congress. First, although press reports have focused on the capital ratio for the entire MMI Fund at 0.24%, in fact, the capital

[5] See pages 20 to 21 of the HUD Report to Congress.

ratio for the most important and by far the largest part of the MMI Fund – the traditional 1 to 4 family 203(b) program - is only 0.12%. This is a ratio of 846 to 1. The much smaller reverse mortgage (Home Equity Conversion Mortgage) part of FHA is projected to have just under a 2% capital ratio and this fact brings the entire MMI Fund to a 0.24% capital ratio.

Looking only at the key single family business, there is only $1.193 billion of economic net worth against $1.009 trillion of insurance in force. Since FHA insures 100% of the loan amount this is $1 trillion of FHA risk in force – potential risk to the taxpayer -- supported by only $1.2 billion of economic net worth.

Second, FHA, continues to suffer heavy losses from its 2007-2009 books of business and especially its loans with seller contributions—a product that ended with passage of the Housing and Economic Recovery Act (HERA) in 2008. The $28.2 billion in capital reserves of the single family program were depleted by $26.9 billion in negative future cash flows on existing business with $24 billion of this negative cash flow attributed to the 2007-2009 books alone.

Looking ahead, under the base case scenario, the FHA actuarial report projects that claim payments in FY 2012 will be over $35 billion or more than twice as much as paid in FY 2011. This will result in a net cash outflow of $19.5 billion leaving the MMI capital resources at only $13 billion at the end of FY 2012 or 60% less than at the end of FY 2011.

In addition to the seller contribution mortgages noted above another important factor in generating the losses to the 2007 – 2009 books is that the FHA premium during those years was set at far too low a level to cover the risk inherent in the loans it guaranteed. As noted above they are still too low, but FHA has taken steps to improve them. Part of the problem is attributable to the fact that FHA insures 100% of the unpaid principal balance of the insured loan amount. This exposes the MMI Fund to the full force of falling house prices, especially in areas which have suffered tremendous house price bubbles followed by serious declines.

The FY 2011 actuarial study notes that the loss severity has been steadily increasing since FY 2003 for the MMI Fund due in large measure to the house price declines. However note the serious loss severity rates as shown in the most recent study. For loans that terminated in FY 2009 the report shows a loss rate of 63.67%.[6] This was up from 59.4% in FY 2008, 49.4% in FY 2007 and 41.75% in FY 2006. In other words, for loans that were terminated in FY 2009 the average loss experienced by FHA equaled 64% of the unpaid principal balance on the loan. The report provides no data on more recent average loss severities but from our own experience in the markets it is highly unlikely that the severity rates fell during the past two years.

[6] See Exhibit E-1, page E-2 of the Report.

Recommendations to improve FHA

- Increase premiums – Although FHA has raised its premiums twice in the past year the current health of the MMI Fund justifies an immediate increase in the premium. The annual premium should be set at the limit to which Congress allows. Current annual premiums are set at either 1.10% or 1.15% depending on the initial down payment by the borrower. FHA has the authority to raise these fees to 1.50% and 1.55% which would clearly improve the finances of the MMI Fund over time. Further to assure that the MMI Fund reserves can be built up to a level that provides a greater cushion for the taxpayer should house prices fall in the near term, we believe that FHA should be required to keep premiums at this higher level until FHA's capital ratio goes back to 2% and for several years thereafter.

- Increase the minimum down payment – In view of the market realities today of falling or stagnant home prices, FHA's down payment requirements should be increased to 5%.

- Change the way FHA's loan limits are calculated – FHA's loan limits should be lowered to what they were prior to the crisis. Importantly, the way FHA's loan limits are calculated is designed to skew them so they are as high as possible. First, FHA uses house price data going back as far as 2008 rather than the most currently available data if the use of the earlier data prevents the FHA loan limit in an area from falling. This means that while some areas of the country have their FHA loan limits set using 2008 median house price data other areas use 2009 data or 2010 data whichever results in a higher FHA loan limit. FHA uses this approach as a result of its reading of the Congressional intent under laws passed in recent years. We believe Congress should instruct FHA to use the most currently available house price data in setting its limits for an area so that the FHA limits are realistic given the change in median house prices for an area over time.

  In addition, currently under law (12 U.S.C. 1709), if a house is located in a county which is part of a Metropolitan Statistical Area (MSA), then the FHA mortgage limit for that county is set at the median house price for the highest priced county within the entire MSA. This means that all counties within a given MSA have the same FHA loan limit and that limit is set at the level of the median house price in the highest priced county. Prior law (before 1998) had FHA set the limit at the higher of either the county median house price or the median house price for the MSA as a whole without reference to the highest priced county within the MSA. We believe that the law should be changed so that FHA is no longer required to target its MSA limits to the highest priced county within an MSA.

- Eliminate GSE fees – The fees charged by the GSEs on top of the MI premium should be eliminated. It is clear that the GSEs are charging these fees as a credit risk mitigation tool. However, there is no indication that these fees go into a regulated reserve structure similar to the reserve structure required for private mortgage insurers. Importantly, if the GSEs believe that they need more credit risk protection for the loans they purchase, they can require deeper MI coverage. In other words, mortgage insurers could insure more than 20% to 30% of the loan amount and the cost to the borrower would be less expensive than the GSE fees in addition to the mortgage insurance premium.

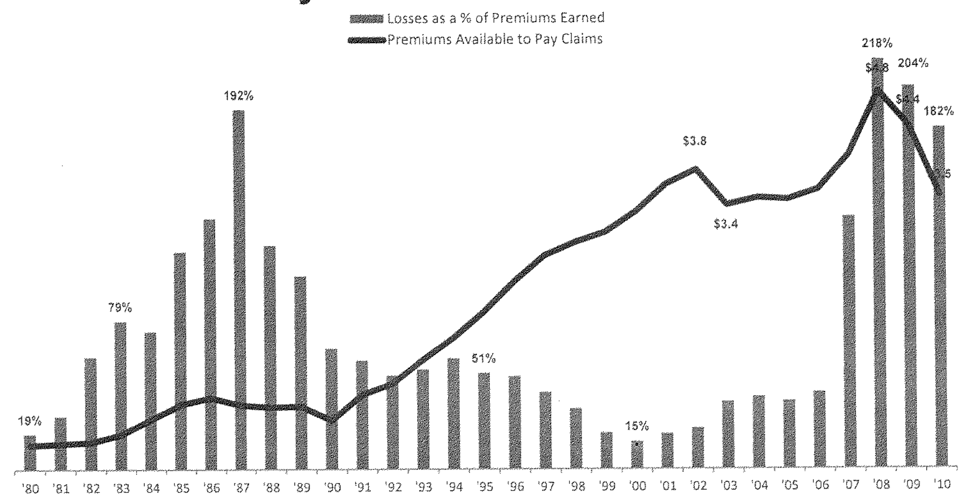
- Work with FHA – As note above private mortgage insurers have a number of strengths that FHA does not have and these have enabled them to survive this present crisis. Primary among those strengths are our analytical tools and underwriting capabilities. MICA believes FHA could be enhanced by exploring with private mortgage insurers new ways to work together to both mitigate taxpayer exposure to losses on low down payment mortgages while better defining the role each of us should play in providing credit enhancement for home buyers. Secretary Donovan has expressed a desire to return FHA's market share to its historical norm and the mortgage insurance industry stands ready to work with him on this issue.

Conclusion

In conclusion, we believe that just like in 1990, FHA is at a crossroads and there are some concrete steps Congress can take to return FHA to actuarial soundness. First, FHA should raise its premiums to the maximum Congress has authorized. Second, FHA should consider raising its minimum borrower down payment. Third, Congress should instruct the FHFA to require that the GSEs eliminate their supplemental loan level fees to avoid the creation of a barrier to the return of private capital to the mortgage system. Finally, the mortgage insurance industry also is willing to work with FHA so that we can build on each other's strengths to better serve the market.

Chart 1

Private Mortgage Insurers Build Capital in Good Times to Pay Claims in Bad Times



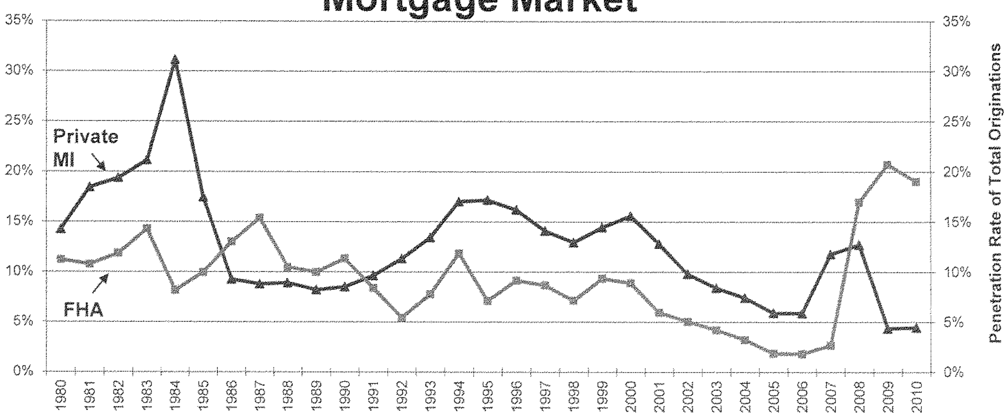
Industry Risk to Capital*: 19.4 21.5 22.4 20.8 22.2 20.2 20.3 17.8 13.5 11.1 9.9 8.0 15.6 21.6

- Mortgage insurance is priced for long-term cycles.
- MIs build capital in good times by setting aside 50% of all earned premiums to pay claims in economic downturns.
- New business in a recovering economy rebuilds the companies' capital base and replenishes their contingency reserves.

*Dollar amount of industry net risk on insured mortgages, divided by industry regulatory capital. Years 2006, 2008, and 2010 risk to capital are adjusted to remove delinquent risk and risk ceded to third-party reinsurance entities.

Source: MICA.

Chart 2
Private Mortgage Insurance and FHA Percentage of Mortgage Market



Total MI & FHA 25% 31% 39% 22% 19% 20% 17% 29% 25% 20% 24% 15% 11% 8% 30% 23%

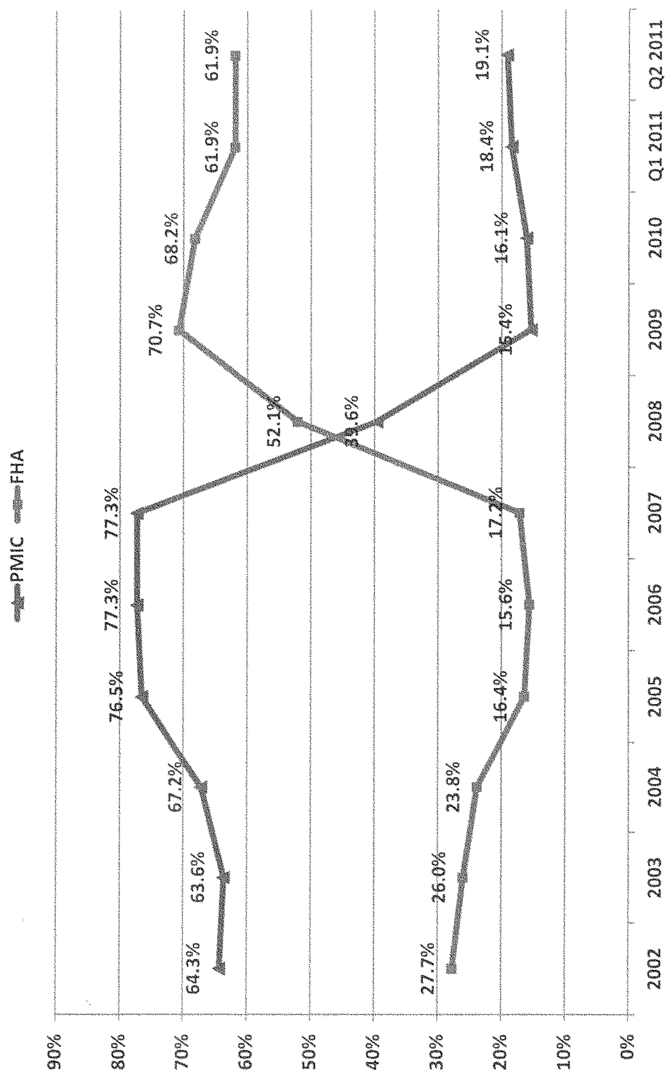
Prudent Low Down Payment Lending Critical to Recovery

Significant Imbalance Between Government Backed and Private Mortgage Insurance

Sources: Private MI data from MICA (excludes HARP), FHA Data from February 18, 2011 Inside Mortgage Finance, Origination Data from March 4, 2011 Inside Mortgage Finance.

Chart 3

Mortgage Insurance Activity: 2002-Q2 2011



Source: November 11, 2011 Inside Mortgage Finance.

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WRITTEN TESTIMONY OF

MAURICE "MOE" VEISSI
2012 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES

HEARING REGARDING

PERSPECTIVES ON THE HEALTH OF THE FHA SINGLE-FAMILY INSURANCE FUND

DECEMBER 1, 2011

Introduction

Chairman Bachus, Ranking Member Frank, and members of the Committee; my name is Moe Veissi. I have been a REALTOR® for 40 years, and am broker/owner of Veissi & Associates, Inc. in Miami, Florida. I currently serve as the 2012 President of the National Association of REALTORS®.

I am here to testify on behalf of the 1.1 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the importance of the Federal Housing Administration (FHA) mortgage insurance program. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential homebuyers. The Association has a long tradition of support for innovative and effective federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure federal housing programs meet their mission responsibly and efficiently.

FHA is an insurance entity within the Department of Housing and Urban Development (HUD) that ensures American homeowners access to with safe and stable financing in all markets. FHA has insured home loans for more than 37 million American families since its inception in 1934, and has never required a federal bailout. While many have recently questioned the program's recent performance, we would argue that, in fact, FHA has shown its considerable strength during the significant housing and economic crisis our country is still experiencing.

In a time when many of the large private banks, investment firms, and other financial institutions have needed bailouts, restructuring or have even collapsed, FHA has weathered the storm very well. FHA continues to have significant resources to pay 30 years' worth of expected claims on their portfolio, which is 30 times more than banks, which are only required by the Financial Accounting Standards Board (FASB) to hold one year of reserves. In addition, FHA continues to have additional reserves of more than $2.5 billion. This is truly an achievement; FHA should be lauded for its financial stability in a most challenging environment and held up as a standard for strong underwriting and risk avoidance.

FHA's Mission

A common misconception exists that FHA was originally intended to only fund modest home purchases and benefit low-income borrowers who could not afford a large down payment on a new home. A review of the program's early loan limits, average prices of homes purchased with FHA loans and loan-to-value ratios demonstrates that this was not the case.

In the program's first years, for example, the maximum insured loan amount was $16,000. While this may seem to be an exceptionally modest amount today, in 1930 only 3.2 percent of homes were valued between $15,000 and $20,000.[1] The majority of values lay between $2,000 and $7,500, with

1. 15th Census of the United States, Population, Volume VI: Families, U.S. Census Bureau, 1930, P. 17

the largest number of these between $3,000 and $5,000.[2] The national median home value was $4,778.[3] So an upper limit of $16,000 in was more than 330% of the median American home value then.

Of course, the $16,000 loan limit does not paint the entire picture of FHA's target demographic. To better understand this, we should look at how the program was used by borrowers. In its third annual report to Congress for 1936, FHA's statistics showed that most of the homes insured were valued in the $3,000 to $6,000 range and the average single-family home value for an insured mortgage was $5,497, more or less reflecting the average costs of homes at the time.[4] Only 2.8 percent of FHA-insured homes were valued below $2,000, and only 2.1 percent above $15,000.[5] This is strong evidence that FHA was not originally targeted to any income group, but rather was intended to help families across the spectrum finance their purchase homes. These statistics varied slightly from year to year, with the size of insured mortgages somewhat lower in 1937 (median 4,288), and then higher in 1938 (median $4,491).[6, 7] In general, these trends have followed income levels of FHA-insured borrowers.[8, 9]

In a similar vein, the original loan-to-value ratio (LTV) limit for FHA mutual mortgage insurance was set at 80 percent. This sounds like a high down payment requirement today, but it was a considerably less constraining than what lenders had previously required. As a result, in 1930 the American homeownership rate was below 50 percent.[10] This change proved very popular: nearly 60 percent of FHA-insured borrowers in 1937 had LTVs between 76 and 80 percent, a jump from 47 percent in the preceding year.[11] Indeed, the lower down payment requirement proved successful enough for FHA to raise the limit again in 1938 to 90 percent for some loans.

FHA's popularization of amortizing loans with lower down payments have led some to propagate the fiction that FHA helps families get into homes they cannot afford. Since the value of insured mortgages has tracked borrower incomes fairly closely, it is no surprise that FHA borrowers have generally not had mortgage payments that are large in comparison to their incomes. In 1937, 61 percent of new FHA borrowers spent less than 15 percent of their incomes on monthly mortgage

2. Id.

3. Id. at 18

4. Third Annual Report of the Federal Housing Administration for the Year Ending December 31, 1936. U.S. Government Printing Office. 1937. P.35

5. Id.

6. Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.58

7. Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938. U.S. Government Printing Office. 1939. P.85

8. Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.61

9. Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938. U.S. Government Printing Office. 1939. P.91

10. 15th Census of the United States, Population, Volume VI: Families. U.S. Census Bureau, 1930. P. 12

11. Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.60

payments, and 92 percent of borrowers paid less than 20 percent.[12] In 1938, 97 percent of borrowers paid less than 20 percent of their incomes on monthly mortgage payments.[13] From the very beginning, FHA was a program helping people purchase homes they could well afford.

The Importance of FHA

With the collapse of the private mortgage market, the importance of the Federal Housing Administration has never been more apparent. As liquidity has dried up and underwriting standards have been squeezed tight, FHA is one of the primary sources of mortgage financing available to families today. Without FHA, many families would be unable to purchase homes and communities would suffer from continued foreclosure and blight. FHA also continues plays a very critical role for those borrowers who are traditionally underserved by the private market. According to the Federal Reserve, FHA insured 60 percent of all African-American and Hispanic homeowners in FY2010. FHA is also the leader in serving first-time homebuyers. In FY2010, FHA insured 56 percent of all first-time homebuyers. In total, of all FHA borrowers, 75 percent were first time homebuyers. FHA also helped many American families refinance into loans with lower interest rates. More than 440,000 homebuyers saved an average of $160 per month, thanks to their new FHA loan.

Despite *not* being subsidized, and being fully funded by the premiums paid by its borrowers, FHA provides also significant benefits to consumers and the FHA fund as the result of the program's focus on foreclosure mitigation. FHA's loss mitigation program includes mortgage modification and partial claim options. Mortgage modification allows borrowers to change the terms of their mortgage so that they can afford to stay in the home. Changes can include extension of the length of the mortgage or changes in the interest rate. Under the partial claim program, FHA lends the borrower money to cure the loan default. This no-interest loan is not due until the property is sold or paid off.

In FY 2011, FHA loss mitigation tools were used to cure 362,000 defaults, and yielded the lowest re-default rates of the past five years. In addition, this year FHA made enhancements to its loss mitigation requirements to increase the use of trial payment periods prior to the mortgagee executing a Loan Modification or Partial Claim action to cure a default. Trial payment plans are expected to reduce re-default rates on loan modifications and partial claims, and thereby reduce costs to the FHA Insurance Fund. By encouraging lenders to participate in these loss mitigation efforts and penalizing those who don't, FHA has successfully helped homeowners keep their homes and reduced the level of losses to the FHA fund.

The universal and consistent availability of FHA loan products is the hallmark feature of a program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity and economic downturn.

12. Id. at 63

13. Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938. U.S. Government Printing Office. 1939. P.95

FHA Strength/Solvency

FHA's 2011 actuarial review demonstrates that its capital reserve fund remains below the Congressionally-mandated 2 percent ratio. The capital reserve ratio reflects the reserves available (after paying expected claims and expenses) as a percentage of the current portfolio, to address unexpected losses. While this is sobering news, most reports have overlooked the fact that the capital reserve fund is not FHA's only reserve fund. FHA also has a cash reserve account separate from the capital reserve. Consequently, FHA's actual total reserves are higher than they have ever been with combined assets of $33.7 billion. This is an increase of $400 million over the previous year.

What the audit confirms is that FHA has "positive" reserves, meaning they have adequate resources to cover all claims and expenses resulting from their portfolio. It is critical to note that FHA's fully capitalized cash reserves account for paying all claims over a 30 year period. By comparison, the Financial Accounting Standards Board only requires financial institutions to hold reserves for losses over the next 12 months. In essence, the FHA loan program has 30 times that amount in cash reserves, with another $2.55 billion in the excess capital reserves, than would be required if they were a privately-held financial institution. In addition, the audit shows that if FHA makes no changes to the way they do business today, the reserves will go back above 2 percent by 2014—sooner than was projected in last year's actuarial report.

The reason the capital reserves have fallen below 2 percent actually is unrelated to FHA's current business activities. There has not been a significant increase in defaults on the part of borrowers, nor underwriting problems experienced by FHA and its lenders. The decline is precipitated by the falling estimates of the value of homes in the portfolio. As such, the decrease in the capital reserve account is a direct reflection of the state of our economy and our housing markets.

Obviously, the economic crisis our country is facing is far beyond the control of FHA. As a Congressional Research Service (CRS) report, published November 23, 2009 stated "FHA would not be able to prevent defaults arising from deteriorating financial and macroeconomic conditions."[14] Given the devastating impact home price declines have had on banks, lenders, and the government sponsored enterprises (GSEs) Freddie Mac and Fannie Mae, FHA has performed remarkably through this crisis. Why? FHA has never strayed from the sound underwriting and appropriate appraisal policies that have traditionally backed its loans. For example, FHA borrowers' credit profile has never been stronger. FHA credit quality has improved steadily since 2007, 4th quarter. Over 50 percent of FHA loans made in every quarter since 2009 (2nd quarter) had credit scores above 680. Today, FHA's borrowers have an average credit score of more than 700, higher than it has ever been—a factor that has helped contribute to FHA's financial reserves.

FHA has met the needs of America's homebuyers, but has never resorted to abusive loans, improper or nonexistent underwriting, or other bad practices. As a participant in the home mortgage process,

14. CRS Report R40937, *The Federal Housing Administration (FHA) and Risky Lending*, coordinated by Darryl E. Getter.

FHA cannot be immune to the pitfalls of the housing crisis. Solid policies and practices have protected it from the biggest failures.

FHA's Recent Changes

For the past several years, FHA has reacted to the lower reserves by making changes to its program. FHA now has a Chief Risk Officer to oversee FHA's efforts to mitigate risk. This was a new position created just two years ago, and we applaud this decision. Assigning one senior staff member with the responsibility for coordinating FHA's risk management activities makes good sense.

FHA has also increased premiums multiple times in the last several years. Beginning in 2010, FHA raised its mortgage insurance premiums three times. FHA's current premium levels are the highest they have ever been in the agency's history. The new annual mortgage insurance premium structure alone led to an increase in the FY 2011 economic value of the Mutual Mortgage Insurance (MMI) Fund of $1.37 billion. We also expect an additional premium increase in the next several months.

NAR strongly supports changes that are vital to retaining the strength and solvency of the FHA fund. However, we do not want to make changes that artificially increase the costs of homeownership in order to fund other government programs and disenfranchise families who wish to purchase a home. Therefore, we strongly urge FHA and Congress to use caution when making changes to ensure that they are necessary for the financial stability of the fund.

NAR Additional Recommendations for FHA

NAR advocates additional changes for FHA to ensure its continued strength and availability to homeowners.

Condominium Rules

Condominiums are often the only affordable option for first time home buyers or borrowers with good credit, but small downpayments. FHA announced updated condominium rules on June 30, 2010, that included some improvements but we continue to have significant concerns with the rules and recommends changes that will provide greater liquidity to this sector of the real estate market without causing additional risk to the Mutual Mortgage Insurance Fund (MMIF). We support enhancements to the rules and limits relating to owner-occupancy, two investor ownership, and delinquent home owner association (HOA) assessments.

NAR recommends elimination of the owner-occupancy requirement for FHA condo mortgages. The GSEs do not have an occupancy ratio for condominium projects if the borrower is going to occupy the unit, which would be the case for all FHA borrowers. Eliminating this requirement will allow more buyers to purchase condominiums which are often more affordable, raise occupancy levels, and stabilize these developments and their communities. If FHA retains the occupancy ratio, NAR recommends amending the rules so that all bank-owned REOs are not counted for the purposes of the occupancy ratio. Again, this will align FHA with industry practices in this area.

FHA made positive changes to the condominium rules but more can be done. NAR, along with a coalition of real estate partners, previously recommended enhancements to concentration and pre-sale requirements that were made permanent in FHA's condominium rules announced on June 30, 2011. However, FHA can provide additional flexibility on condominium recertification requirements and fidelity insurance coverage requirements. NAR also recommends FHA reconsider the elimination of the Spot Loan Approval Process. Spot loans can be critical for borrowers who wish to use FHA to purchase a condominium in a project that is not FHA approved.

Mortgage Loan Limits

We also strongly support making permanent the FHA mortgage loan limits that are currently in effect. FHA has played a critical role in providing mortgage liquidity as private financing has dried up. We applaud Congress for extending the current loan limits through 2012, but strongly believe that these limits need to be made permanent.

In today's real estate market, lowering the loan limits restricts liquidity and makes mortgages more expensive for households nationwide. FHA and GSE mortgages together continue to constitute the vast majority of home financing available today, which makes it particularly critical that the current limits continue. Without the additional liquidity created by maintaining loan limits at current levels, families will have to pay more to purchase homes, face the possibility that they will not be able to obtain financing at any price or find it more difficult or impossible to refinance problematic loans into safer, more affordable mortgages.

Many argue that the loan limit increases help only the higher cost areas, but this is not the case. According to a recent HUD report, only 3 percent of FHA loans are above $362,750, and less than 2 percent are above $417,000. But decreasing the loan limits would impact 612 counties in 40 states plus the District of Columbia. More than 100 counties throughout the Midwest and more than 200 counties in the South would experience declines averaging more than $64,000. The majority of markets that were impacted by the loan limit decline are NOT high cost. If the limits were to fall, more than half of all existing homes nationwide will be ineligible for FHA mortgage financing. If families cannot obtain financing to buy, sellers will need to further reduce the price on their home. This will further erode the wealth of American families and will prolong the nation's economic recovery.

In addition, higher balance FHA loans perform better than lower balance ones. According to the FY 2010 audit, "FHA experience indicates that more expensive houses tend to perform better compared with smaller houses in the same geographical area, all else being equal." So despite arguments that FHA higher limits put taxpayers at risk, these loans actually add strength to the program, and reduce risk to the fund.

We strongly support the legislation introduced by Committee members Brad Sherman (D-CA) and Gary Miller (R-CA), H.R. 1754, the "Preserving Equal Access to Mortgage Finance Programs Act" to make the current loan limits permanent. We urge the Committee quickly consider this important legislation to ensure that liquidity in this tenuous market is not put at risk.

FHA's Role in Multifamily Markets

As in the single-family market, FHA's role in multifamily mortgage markets has never been more critical. More than one third of American families rent their homes, and keeping a sufficient supply of affordable rental housing is essential. Without the liquidity provided by FHA multifamily mortgage insurance, these markets would be stalled.

In recent years, FHA's role in the multifamily market has increased dramatically—nearly 4 times its size from just several years ago. As lenders remain slow to provide financing for construction loans, FHA is the primary source of construction for multifamily developers and owners. Again, this demonstrates FHA's ability to step up and fill the gap when private markets will not or cannot act.

FHA has implemented a number of new procedures and requirements for its multifamily loans. They have strengthened underwriting by changing ratios and increasing documentation. They have also implemented a number of oversight and risk-management provisions.

In response to the increased demand and the changes to the program, FHA's ability to meet the needs of developers to create affordable rental housing has been challenged. FHA is working hard to meet the new demands responsibly. We urge them to look for ways to streamline procedures.

Multifamily Loan Limits

We strongly urge Congress to pass legislation to increase the FHA Multifamily loan limits in high-rise properties. High rise construction has costs significantly different than garden-style apartments. Yet the loan limits for the two very different types of units are nearly the same. Because the so-called "elevator" limits are so low, many urban areas have not had any properties endorsed with FHA multifamily insurance in the last several years. Since there is very limited private capital available, and high demand for affordable rental housing, our nation's urban dwellers are suffering. We urge Congress to pass legislation to increase the elevator loan limits for multifamily to assure all our nation's families can find affordable rental housing.

FHA Into the Future

FHA is performing exactly the role it was designed to do. It is filling the gap when the private market is not engaged in the market. Already, we have started to see FHA's market share drop as a tentative private investment considers returning to mortgage markets.

It can be argued that FHA's market share is a good indicator of the state of housing markets. When FHA was at 3 percent of the market, it should have been a warning sign that we were in a troubled mortgage market, with abusive lenders wooing homebuyers away from safer, stable mortgage products. Conversely, with FHA such a huge portion of the market today, it is clear that the private market has yet to rebound. Historically, FHA's market share has hovered between 10 and 15 percent of the market. We believe this is an appropriate share for the FHA program over the long run. We look forward to FHA's continued declining market share, as private lenders step up to meet the needs of American homebuyers.

However, this decline must be allowed to happen gradually and naturally, as confidence in mortgage markets returns and encourages private investment to once again provide for the needs of the majority of qualified borrowers. Although FHA market-share has begun returning to historic levels, we aren't out of the woods yet. Our recent research found that nearly 33 percent of the market today is composed of cash buyers, a great number of whom are investors rather than families looking to buy a home. The current market conditions are not healthy for American homebuyers, homeowners or real estate markets. We welcome a return to a stabilized market, with access to safe, affordable mortgage credit for American families.

Conclusion

The National Association of REALTORS® feels strongly about the importance of the FHA mortgage insurance program and believes FHA has shown tremendous leadership and strength during the current crisis. Due to solid underwriting requirements and responsible lending practices, FHA has avoided the brunt of defaults and foreclosures facing the private mortgage lending industry. We applaud FHA for continuing to serve the needs of hardworking American families who wish to purchase a home.

We wholeheartedly support the FHA program and we stand ready to work with Congress to enhance FHA's mission, service and purpose. We thank you for this opportunity to testify, and look forward to working with you to accomplish our recommended proposals.

Center for American Progress Action Fund

Sarah Rosen Wartell
Executive Vice President
Center for American Progress Action Fund

before

The Committee on Financial Services
United States House of Representatives

hearing on

"Perspectives on the Health of the FHA Single-family Insurance Fund"

December 1, 2011

Good morning Chairman Bachus, Ranking Member Frank, and members of the committee. Thank you for the opportunity to testify today about the financial status of the Federal Housing Administration's Mutual Mortgage Insurance Fund. I applaud the chairman for convening this hearing to address this important topic.

I'd also like to take this opportunity to thank Ranking Member Frank for his more than 30 years of service in the U.S. Congress. Over the years, I have had the privilege of having my arguments tested and challenged by Rep. Frank a number of times and my positions were always much improved by his insights and razor-sharp questioning. I expect that after a productive year in the House in 2012, he will continue to challenge us all to do our best for American families from wherever he chooses to engage in the policy debate.

In the wake of the worst housing crisis in more than 80 years, concern has arisen that FHA could run out of money and require taxpayer support. Despite some inflated claims, today's FHA does still have adequate funds to cover all expected losses with a small additional reserve (under the most widely subscribed assumptions about home values) and is expected to get stronger in the coming years. FHA's immediate financial future, however, does rely upon stability in the U.S. housing market.

Let me begin by making a few central points on the financial status of FHA:

- Historically, FHA has played a central role in keeping liquidity available in the mortgage market in times of economic duress, as we are now observing firsthand. This role has been critical in the most recent crisis. Without FHA, more than a million homeowners likely would not have had access to mortgage credit in the wake of the financial crisis, which would have further chilled housing demand, further depressed home prices, and exacerbated the economic downturn.

- In fact, it is remarkable that FHA has not required supplemental support to date, given that so many of our private institutions needed temporary help to emerge from the crisis. FHA has so far weathered the worst housing collapse since the Great Depression—arguably in history—all while maintaining an insurance portfolio serving primarily low- and moderate-income borrowers and playing a key countercyclical role that has prevented a more devastating over-correction in the housing market. This is testament to the tools FHA has, where stronger books of business help cover losses from the earlier years.

- FHA's current financial position is the result primarily of significant losses in loans insured in the years immediately preceding the financial crisis. But its recent books of insured loans are projected to have significant net economic value to FHA.

- The capital reserves in FHA's Mutual Mortgage Insurance Fund—the insurance fund maintained by FHA to protect taxpayers from losses—are uncomfortably low, but under reasonable (although not certain) economic assumptions, FHA will be able to recapitalize the reserve without taxpayer support. More than anything else, FHA's solvency depends on whether and the extent to which housing prices continue to fall in the next two years.

- Even if home prices continue to fall, FHA still has tools at its disposal to bolster its reserves without taxpayer dollars. In particular, FHA can make premium adjustments and can further tighten underwriting standards.

- In the future, I believe FHA should prioritize premium adjustments over higher down payment requirements. Historically low interest rates leave room for borrowers to absorb slightly higher fees without creating an affordability barrier to access. In contrast, higher underwriting standards and higher down payment requirements, on top of existing tightened standards, could make it difficult for a broad swath of homeowners to obtain mortgages, putting further downward pressure on housing demand and thus contributing to continued home-price weakness and further risk to the MMI Fund.

- As we move toward a new system of housing finance that works for American families, FHA will continue to be a critical source for mortgage capital in underserved sectors of the market. Congress should consider long-term reforms to equip FHA with the talent, resources, and authority in needs to adapt quickly and nimbly to market changes, helping it better manage taxpayer exposure to risk.

- Risk sharing is another promising way FHA can limit its exposure. Full insurance coverage is necessary in many areas of FHA business, but under certain conditions and with some products the government may be able to reduce risks by taking advantage of the private sector's risk assessment and mitigation capacities.

Historically and today, FHA plays a critical role in providing liquidity in the mortgage market during times of economic stress.

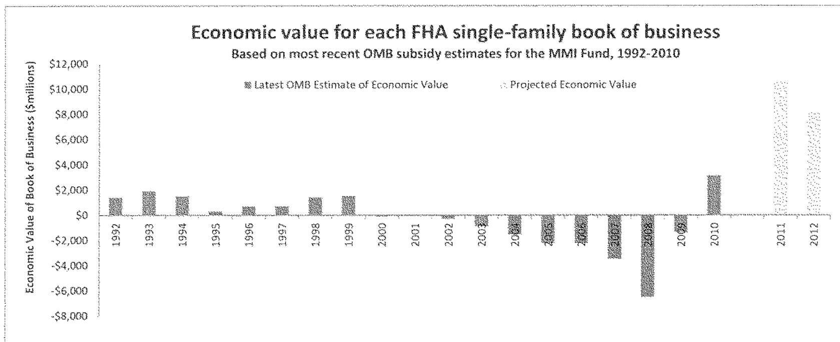
Before I discuss FHA's current financial condition, it's important to put today's situation in historical context. The Federal Housing Administration was established in 1934 to help promote long-term stability in the U.S. housing market. For close to 80 years, FHA consistently maintained a small but meaningful share of the market, focusing on first-time homebuyers and creditworthy low- and moderate-income borrowers. FHA was also integral to creating and popularizing the 30-year fixed-rate self-amortizing mortgage, now a pillar of U.S. housing finance.

Together with Ginnie Mae, which facilitated secondary market access for FHA-insured loans, FHA's guarantee of mortgage debt helped to ensure that credit was continuously available under terms and at prices that made sustainable homeownership possible for many American families.[1] To date, FHA has accomplished these goals at little to no cost to taxpayers.[2]

A key way FHA promotes stability in the market is by providing countercyclical liquidity, today as in 1934. When private capital withdraws from the housing market in uncertain economic conditions, FHA expands its activities to ensuring mortgage capital remains available and

American families can find buyers for their homes. To insulate itself from the increased risks it is taking, FHA has historically tended to tighten its underwriting standards or raise premiums during these countercyclical periods when its market share is expanding.

By the very nature of its activities, including providing countercyclical liquidity, FHA's business does not always maximize profits. Some books of business yield a positive economic value, while others have a negative value. In simple terms, FHA's long-term financial health depends on building a strong capital cushion from well-performing books so that it can continue to reach underserved borrowers and to do business in stressful periods when other credit providers withdraw.



FHA's role during the so-called "oil patch" contraction of the 1980s is a good example of how it provides countercyclical liquidity. After years of rapid growth fueled by booming oil prices, states like Texas, Louisiana, and Alaska fell into a deep recession in the early 1980s when the oil market began to tumble, leading to a collapse in local housing markets. Following the historical trend, private lenders responded by withdrawing from these markets, threatening to turn a housing downturn into a severe bust, with dire economic consequences for these regions. During this period, FHA played a critical role by significantly increasing its mortgage insurance activities, helping to ensure that sufficient liquidity remained available and that problems in these regional housing markets did not lead to more dire economic problems.

But of course, providing this countercyclical liquidity to troubled housing markets had the effect of adding significant new risk to FHA's portfolio. Nearly half of the claims FHA paid out on loans originated in 1985 to 1986 came from the oil patch states of Texas, Oklahoma, Louisiana, Colorado, and Alaska, according to *Mortgage Banking*.[3] And FHA would insure more mortgages between 1986 and 1990 than it did in the previous 13 years combined.

FHA responded to this increased risk by tightening its underwriting standards with over 30 measures, including stricter compensating factors for borrowers above credit ratio guidelines.[4] These measures were quite successful in mitigating the potential risks that FHA took on during its period. By the early 1990s the oil patch states recovered, FHA's market share returned to historic norms, and the agency managed to build up its capital reserve without help from taxpayers.

The problem FHA faces today is in many ways similar to the oil-patch recession, albeit much more pronounced and on a much larger, and more national, scale.

Starting in the late 1990s and early 2000s, new private mortgage products and providers emerged to target the budding subprime and Alt-A markets. Many of these products competed directly with FHA insurance programs, often with artificially low prices based on an underestimate of the true risk of the underlying loans.

Ironically, and contrary to the conclusions of many of the critics of the government's role in mortgage finance, the private sector was actually significantly worse at pricing risk than the government during the recent housing bubble. This underpricing of risk gave privately originated subprime and other exotic mortgages a competitive edge over more traditional products, such as FHA-insured mortgages. They also enabled the loan brokers to make much larger upfront fees than with traditional FHA loans.

As private subprime lending took over the market for low- and moderate-income borrowers, FHA saw its market share plummet in the mid-2000s. In 2001 FHA insured 14 percent of home purchase loans. By 2005 that number shrank to 4 percent.[5]

The rest of the story is well known: The influx of new and largely unregulated private subprime lending contributed (along with other factors) to a massive bubble in the U.S. housing market. By 2008 the bubble had burst in a flood of defaults, leading to a near collapse of the American mortgage market. Mortgage giants Fannie Mae and Freddie Mac were placed under government conservatorship and significantly tightened their underwriting standards, conventional lenders pulled back, and subprime lending essentially came to a halt.

True to its role to provide countercyclical liquidity, FHA's lending activity surged to fill the gap left by the moribund non-agency mortgage market and constrained agency business. In 2009 FHA insured 56 percent of home purchases and about 35 percent of all mortgage loans (home purchases and refinances), a level not seen since World War II.

If FHA had not stepped in, increasing activity more than fourfold between 2007 and 2009, the housing market would be in much worse shape than it is today. Without FHA hundreds of thousands—perhaps even millions—of homebuyers would not have purchased houses over the past three years, shut out of the market because of a lack of available finance. And the 56 percent of all first-time buyers[6] and 60 percent of all African American and Latino homebuyers[7] that rely on FHA financing today likely would have had nowhere else to turn when private lenders tightened their underwriting standards.

Families that needed to move for new employment or to finance retirement would have found few buyers, the glut of unsold properties would have grown larger yet, and many more families would have found their mortgages underwater. And the further decline in real wealth would have chilled economic activity even further.

FHA's current financial position is the result primarily of significant losses in loans insured in the years immediately preceding the financial crisis. But its recent books of insured loans are projected to have significant net economic value to FHA.

Before we look to the future, it's important to understand the highest risks in FHA's current insurance portfolio. FHA continues to suffer big losses from higher-than-expected foreclosure rates on mortgages insured before the bubble burst, particularly in its 2006 and 2007 books of businesses. As private actors began to withdraw from some market segments, originators turned to FHA to sustain their volume, before FHA put in place appropriate controls to stem risks in this new business.

FHA's independent actuaries, Integrated Financial Engineering, Inc., predict as many as half of all low-FICO score and high-loan-to-value loans insured at the peak of the housing bubble will ultimately result in loss for FHA. They also estimate more than 1 out of every 4 loans insured in 2007 alone will result in an insurance claim. [8]

Books from the mid-2000s also carry unexpected risks due a high number of loans with little or no borrower-paid down payments. Prior to 2008, FHA endorsed a large number of so-called "seller-financed down payment assistance loans," in which sellers covered the required down payment at the time of purchase in exchange for inflated purchase prices. These loans experienced claim rates that are considerably higher than otherwise comparable non-assisted loans, according to the actuarial report.[9] These often-fraudulent assistance programs were later banned from FHA insurance programs by the Housing and Economic Recovery Act of 2008.

Starting in 2001 there was also a rapid increase in the share of loans with "gift" down payment assistance from nonprofit, religious, or community institutions, increasing to almost 25 percent of FHA loans in the 2005, 2006, and 2007 books of business. These loans have performed worse than loans with no form of down payment assistance, making claim risks for these books particularly high, according to the actuarial report.[10]

As an example, loans with "gifts" from nonprofit organizations in the 2005 book had a claim rate of about 17 percent, while loans with no down payment assistance in that book had a claim rate of less than 7 percent.[11]

To be sure, many nonprofits, states, and local governments provide essential down payment assistance that does not meaningfully affect the borrower's risk of default. It's also worth noting that several "nonprofits" issuing this assistance were in fact fronts for developers and sellers. So while certain types of assistance may negatively impact the economic value FHA's books, it does not necessarily mean that these programs should be scaled back.

And as bad as these rates are, they are much better than the rates for private subprime lending during this period. By comparison, more than 20 percent of subprime loans originated in 2006 and 2007 defaulted within 12 months, according to the Federal Reserve Bank of Chicago.[12]

While losses from these pre-crisis books will likely continue for several years, FHA's post-crisis books are expected to have significant positive net economic value, due in part to increased fees and tightened underwriting standards. The 2011 book, for example, is expected to bolster the MMI fund's reserves by $10.5 billion, while the new 2012 book of business is projected to add another $8.1 billion, according to the actuarial report.[13]

FHA currently insures about a third of all home loan purchases in the United States, well above historic norms. As the housing market recovers, FHA's share should and will return to its historical norms. But as long as the current housing crisis continues, and private mortgage lenders continue to stay on the sidelines, FHA will continue remain a critical option for ensuring that affordable mortgage capital remains available for potential homebuyers.

The capital reserves in the MMI Fund are uncomfortably low, but under reasonable although not certain economic assumptions FHA will be able to recapitalize the reserve without taxpayer support.

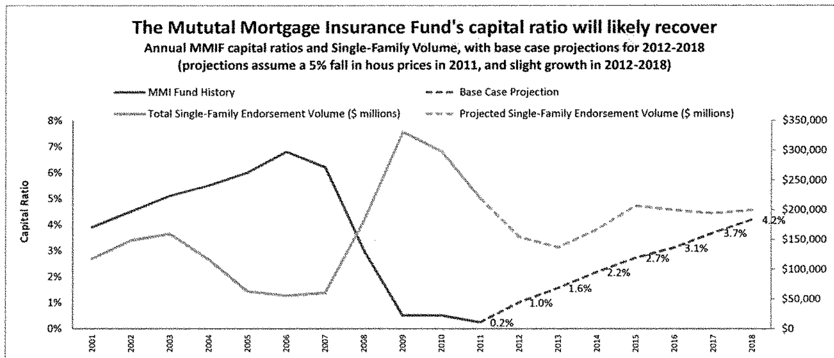
FHA recently released its annual financial report and independent actuarial review for the MMI Fund, which covers virtually all of the agency's single-family insurance programs. Most of the numbers I cite in this testimony come directly from those reports.

The most closely-watched statistic in the financial report is the so-called "capital ratio," the amount of excess cash the agency has on hand to cover unexpected insurance claims, reported as a percentage of total insurance in-force. For the past 20 years, Congress has mandated that FHA maintain a capital ratio of 2 percent, meaning it keeps an extra $2 on reserve for every $100 of insurance liability. The MMI fund's current capital ratio is just 0.24 percent, about an eighth of the legal threshold, according to the report.[14]

This is a serious problem, but not one that should be overstated. First, it's important to understand what exactly we're talking about here. As required by law, the MMI Fund still holds about $30 billion in its so-called "financing account" to cover all expected insurance claims over the next 30 years. The capital ratio measures the *additional* cash reserves to cover any *unexpected* losses beyond this reserve for expected losses.[15]

So even when that ratio falls below the 2 percent threshold, FHA still has cash on hand to cover its immediate insurance liabilities. Think of it as the difference between a checking account you use to pay your bills and a savings account you keep tucked away for a rainy day.

Secondly, while the MMI Fund's capital ratio is currently uncomfortably low, it will likely recover in the coming years, even if the current malaise in the housing market continues. FHA predicts the ratio will return to the 2 percent threshold by 2014, assuming a 5 percent fall in house prices in 2011 and a slight rebound in subsequent years.[16] The predicted recovery is attributable to the high expected economic value of the 2010 through 2012 books of business.



Under the same assumptions described above, FHA's actuaries expect the economic value of the MMI fund—the amount of excess cash on hand to cover unexpected claims—to rise by an average of $8.3 billion per year through 2018. The fund's capital reserve is projected to increase from its current level of $1.2 billion to about $60 billion over the next seven years.[17]

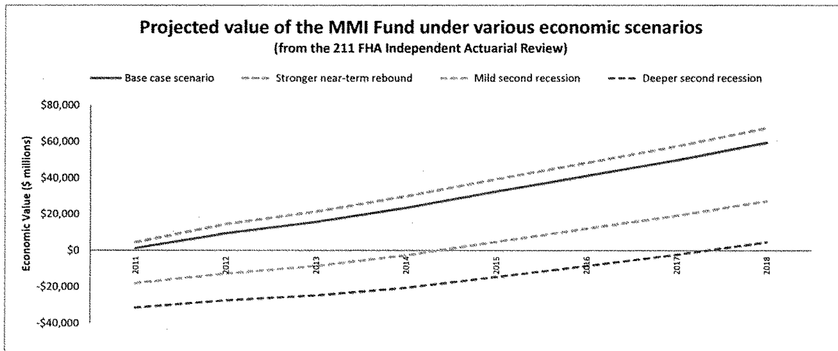
If that indeed turns out to be the case, it would be quite a remarkable accomplishment for FHA. The agency will have weathered the worst housing crisis since the Great Depression—arguably in history—without a government bailout, all while maintaining an insurance portfolio that largely targets low- and moderate-income borrowers. We should all be grateful for FHA, for without it the housing market—and the economy as a whole—would be in much worse shape than it is today.

Of course, all of the above predictions assume a relatively stable housing market in the coming years. Like most private insurers, FHA's performance is heavily dependent on the health of the sector it insures: housing, and particularly fluctuations in home values. When home prices fall, borrowers who suffer unemployment or other shocks are more likely to default on their mortgages, and FHA also recovers less in the event of a default. Both factors result in bigger losses for FHA.

Which brings us to the multibillion-dollar question before us today: What happens to the MMI Fund if housing prices fall significantly again?

According to FHA's financial report, if home prices fall another 9 percent over the next two years, the MMI Fund's capital reserve will likely run dry, meaning FHA will no longer have reserves for unexpected future claims. Such a scenario, if measures are not taken in advance to bring in more revenue, could force FHA to seek taxpayer dollars for the first time in its 77-year history.[18]

The independent actuarial review confirms that under more pessimistic economic scenarios, in which the housing market enters into a "mild second recession," the MMI Fund could have a "negative economic value" by the end of this fiscal year, meaning it will not even have enough cash to cover all expected future claims. And in the case of a "deeper second recession," the MMI Fund's capital reserves could be as much as $31.5 billion in the red by the end of the year.[19]



It's worth noting that the worst two-year period recorded by the Federal Housing Finance Agency was at the height of the housing crisis, when prices fell just under 13 percent between the second quarter of 2007 and the second quarter of 2009.[20] And housing prices nationally are already down about 30 percent from their peak in 2006, and in some hard-hit communities it's closer to 50 percent.[21]

With house prices having already fallen quite far, many notable economists predict home prices will bottom out sometime next year and start rising modestly in 2012, including forecasters at Freddie Mac,[22] Moody's Analytics,[23] the National Association of Realtors,[24] the Mortgage Bankers Association,[25] and Fiserv.[26]

To be sure, other forecasters are less optimistic, but very few predict another double-digit drop in the coming years. For example, the real estate firm Zillow expects prices to decline another 3 to 5 percent before reaching a definitive bottom in 2012 "at the earliest."[27] And PIMCO recently estimated that U.S. home prices may drop another 6 to 8 percent before they hit bottom.[28]
All things considered, FHA's actuaries estimate about a 50-50 chance the MMI Fund will maintain a positive capital reserve in the coming years, with no policy changes.[29]

If home prices do not turn around soon, FHA still has tools at its disposal to bolster its reserves without taxpayer dollars.

No one can be certain what will happen in the housing market over the next few years, but that hasn't stopped some analysts from sounding the alarm of an impending FHA bailout. A recent report from Joseph Gyourko of the Wharton School, commissioned by the American Enterprise Institute, predicted FHA will require recapitalization of "at least $50 billion, and likely much more," even if housing markets do not deteriorate severely. Only "quick and substantial economic and housing market recovery," Gyourko writes, is the "primary way for FHA to avoid generating substantial losses for American taxpayers."[30]

But Gyourko's analysis overstates the case. First, his $50 billion number is an estimate of the total capital necessary for the MMI fund to meet the required 2 percent ratio. This estimate disregards the nature of that countercyclical mandate, especially during times of economic duress.

Title II, Section 207 of the 1990 Cranston-Gonzalez National Affordable Housing Act states that FHA should have a "capital ratio goal of at least 2 percent." When the ratio falls below that level, the secretary of Housing and Urban Development must "advise the Congress of any administrative measures being taken to attain and maintain a capital ratio of at least 1.25 percent, and make any legislative recommendations that the Secretary deems appropriate." [31]

In other words, FHA need not regenerate its capital reserves in one fell swoop. By law, the HUD secretary is required only to come up with a viable recapitalization plan.

When Congress instituted the capital ratio requirement in 1990, it gave HUD ten years to increase its capital from zero to 2 percent. It took only three years for FHA to reach the threshold, thanks in part to increased insurance premiums.[32] This is an example of how countercyclical capital works, in contrast to the pro-cyclical tendencies that characterize the private mortgage market and have brought us both boom and bust.

FHA has already taken many of the necessary steps to bolster its capital reserves. For starters, FHA has increased insurance premiums three times since 2009 to the highest levels in its history. The new premium structure alone increased the economic value of the 2011 book by $1.37 billion, according to the annual financial report. [33]

The agency has also significantly tightened underwriting standards. Under new rules, borrowers with FICO scores below 580 are now required to put down a minimum down payment of 10 percent, or have equity of 10 percent at the time of refinance. Only borrowers with stronger credit are eligible for FHA-insured mortgages with the minimum 3.5 percent down payment.

FHA purchase mortgage insurance continues to be a low down-payment business, with 85 percent of loans insured in 2011 having down payments of less than five percent; in recent years, however, FHA has taken steps to control the source of those payments, particularly by reducing the number of risky seller-funded down payment loans. While sellers funded 37 percent of FHA down payments in the first quarter of 2008, there were virtually none in the 2010 and 2011 books of business. Three quarters of down payments were made with borrower funds in 2011, compared to less than 45 percent in the first quarter of 2008.[34]

Tightened standards—and the lack of available private-market alternatives for many borrowers—means that FHA borrowers now have much better credit than in previous years. Nearly half of FHA borrowers had FICO scores below 620 in 2007; for the 2010 and 2011 books of business, only 3 percent of borrowers were below that threshold. For the first time in the agency's history, more than half of FHA borrowers had a FICO score of more than 700, according to the annual report. [35]

FHA has also overhauled its single-family loan review policies and procedures, resulting in a number of changes to strengthen monitoring of FHA lenders.[36] HUD also now requires FHA-approved lenders to have a net worth of at least $1 million. [37]

Loan delinquencies and defaults have declined dramatically in recent months. The single-family portfolio's ninety-day delinquency rate, often the first indication of strength or weakness of new insurance commitments, was just 0.3 percent in early 2011, a new post-crisis low. As a comparison, that so-called "early-period" delinquency rate was more than eight times higher at the peak of the foreclosure crisis in 2007.[38]

The portfolio's "serious" delinquency rate, which tracks delinquencies after 90 days, has also declined steadily for the past two years, from 9.44 percent in early 2010 to 8.18 percent in the third quarter of 2011. And the quality of FHA's loan portfolio seems to have improved since the crisis: serious delinquency rates for the 2009 and 2010 books of business are substantially lower rates than the 2006-2008 books.[39]

In the future, FHA should prioritize premium adjustments over further tightening underwriting standards. If we place undue restrictions on FHA it could create additional weakness in the housing market, potentially also hurting the health of FHA.

Depending on what happens with home prices in the near future, FHA may need to take further steps to bolster its capital reserves. FHA traditionally does this by either tightening underwriting standards or by adjusting premiums. If further measures are required, I urge FHA to prioritize premium adjustments over further tightening underwriting requirements, especially overly tightening loan-to-value ratios.

The primary benefit of upfront premium increases is that they quickly generate revenue to the MMI Fund; the benefit of reduced claims from tightened underwriting is felt over a longer period, by which time, the MMI Fund may well have recovered, as current and future year larger books of business with projected positive net economic value would have matured and bolstered the fund.

In addition, at a time of historically low mortgage rates, there is room for FHA to increase its fees without having a meaningful impact on access to credit. This is especially the case for large-size FHA loans, which currently play a larger role in FHA business than in other periods. One option would be to differentiate premiums so that higher loan amount mortgages pay higher premiums.

However, further tightening underwriting standards, especially by increasing minimum down payments, will likely reduce both FHA's volume and the overall size of the mortgage market and put downward pressure on home values – limiting FHA's ability to play the countercyclical role. This could negatively affect FHA's financial health in the long run, as the agency is so dependent on the health of the housing market. And a strong housing market mitigates taxpayer exposure to risk through losses from Fannie Mae and Freddie Mac.

Furthermore, these decisions would be in tension with FHA's mission to support communities especially hard-hit by the foreclosure crisis, many of which saw significant home equity stripped by subprime and predatory lending. In these neighborhoods, without reasonable access to FHA, housing markets would be stagnant and the prospects of recovery would diminish.

Other reforms could help strengthen FHA and better equip it to protect taxpayers from risk.

FHA has the capacity to make tough decisions and some statutory flexibility to adjust its risk exposure to protect the taxpayers. But Congress must make sure FHA also has the resources it needs to soundly manage a $1 trillion insurance portfolio.

I have long been a proponent of plans to modernize FHA into a modern financial institution with the staff, systems, and authority to adapt quickly to market changes, helping it better manage taxpayer exposure to risk. This will likely require significant structural and operational reforms, starting with the staff.

A recent GAO report found that while FHA business volume and workloads have increased significantly in recent years, staffing levels have stayed about the same.[40] This is not just a numbers issue; it's also a matter of skill and relevant market experience. While federal financial regulators like FDIC and SEC are allowed to pay appropriate salaries for employees with special skills, FHA salaries are subject to lower federal-employee caps. I believe Congress should reconsider these restrictions.

In addition according to FHA's 2010 actuarial report, the agency's "current financial system is comprised of numerous aging information systems developed independently over the last thirty years," which will "continue to require expensive maintenance and monitoring and are likely to pose increasing risks to the reliability of FHA's financial reporting and business operations." [41]

FHA deserves credit for launching the "FHA Transformation Initiative," a multi-year effort to acquire and employ a modern financial services information technology environment. [42] Appropriate levels of funding in the coming years will be required to ensure that improvements are made that protect taxpayers.

Risk sharing is another promising way FHA can limit its risk exposure. Most FHA programs offer 100-percent government insurance. Full coverage may be needed during periods of market stress, when private capital is reluctant to take housing risk, or when serving underserved populations and pioneering new products. However, in some circumstances and with some products, the government may be able to reduce its exposure through a variety of risk-sharing structures that align the interests of private actors and the taxpayer and so take advantage of private sector risk assessment and mitigation capacities. I urge Congress to consider granting FHA more flexible risk-sharing authority so it can determine when risk sharing is appropriate for its single-family business.

I know from my experience at FHA from 1993 to 1998 how extraordinarily challenging it can be to make restructuring, personnel, systems, and product changes at FHA. The barriers to reforms that would both reduce FHA risk and improve its effectiveness are significant.

So I encourage the Congress to reconsider, as part of overall housing finance reform, a proposal first put forth by Secretary Henry Cisneros during his tenure at HUD. [43] That proposal would have transformed FHA into a more nimble but disciplined government corporation, with strict and independent oversight of its performance in serving underserved markets and maintaining financial soundness, but greater flexibility in product design and personnel, among other factors, to meet those ends. Similar recommendations were endorsed by the Millennial Housing Commission in their report submitted to Congress in May 2002. [44]

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For more than 75 years, FHA has helped to provide liquidity and enhance stability in the U.S. mortgage market. Emerging from the Great Depression, it transformed housing finance by demonstrating how long-term, fixed-rate mortgages can help middle-class families better plan for the future in uncertain economic times. Despite its current financial difficulties, FHA has played an important role in improving the economic condition of everyday American families at a uniquely challenging time in our history.

FHA is and will continue to be a critical part of an effective U.S. housing market under any version of a reformed system under consideration. But its future role very much depends on how Congress and the administration decide to wind down the government-sponsored enterprises, Fannie Mae and Freddie Mac, currently in government conservatorship and build a new housing finance system built in their place. On the one hand, if Congress strips all government support from the market formerly covered by the GSEs, FHA will likely be forced to maintain or even grow its substantial market share.

On the other hand, if the government maintains an explicit guarantee on certain types of mortgage debt and charges for its backstop so it can hold actuarially sound reserves against its obligations—much like the proposal released by CAP's Mortgage Finance Working Group[45]—FHA will be able to return to a more manageable share of the market when prices stabilize.

FHA's immediate financial future is inextricably linked to the health of the housing sector—and the economy as a whole—in the coming years, and the recent financial reports remind us just how vulnerable FHA is to broader economic conditions. But this warning should not be overblown; with prudent management, there's still a good chance the agency will weather the steepest housing downturn since its creation without taxpayer support.

Helping the housing market recover and growing the economy must be a top priority for Congress and the Obama administration. With a stronger economy and housing market, FHA's current financial condition will likely improve on its own.

In closing, I would like to commend the chairman and the other members of this committee for attention to this important topic. If the recent financial crisis taught us anything, it's that we must closely monitor the business practices and actuarial health of our essential financial institutions. Congress and FHA officials together can ensure that FHA continues to play its essential role while protecting the taxpayers.

Thank you. I would be happy to take any questions.

ENDNOTES

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[2] FHA does not keep the revenues generated by its insurance programs; they are deposited back into the Treasury. Each year, FHA receives a small appropriation for operational expenses - Congress appropriated $188,900,000 to the FHA Mutual Mortgage Insurance Fund for fiscal Year 2011 - but much or all of that was funded by FHA's excess revenues from previous years. (See http://portal.hud.gov/hudportal/documents/huddoc?id=FHA_Fund_MMI_Fund_2_2012.pdf)
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[17] Integrated Financial Engineering, Inc., *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year.* (U.S. Department of Housing and Urban Development 2011). Available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu

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Statement of Brian Chappelle
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Hearing before the U.S. House of Representatives
Committee on Financial Services
on
"Perspectives on the Health of the FHA Single-family Insurance Fund

Thursday, December 1, 2011

Chairman Bachus, Ranking Member Frank, and Members of the Committee, thank you for the opportunity to provide this statement on the health of the FHA Single-family Insurance Fund.

We are now more than four years removed from the collapse of the housing market and the Federal Housing Administration remains actuarially sound according to its FY 2011 Actuarial Review and is now expected to return to a capital ratio above 2 percent in 2014.

The primary reason for the independent actuary's conclusion is the outstanding performance of the FHA loans insured since 2009. In fact, loans insured since 2009 generate over $18 billion of economic value for the fund. Accordingly, instead of becoming the "subprime dumping ground" like some critics predicted after the subprime market collapsed, FHA has been able to weather the worst economic conditions since the Great Depression because of the exceptional quality of its recent books of business.

FHA's cash reserves also increased in FY 2011 to over $33 billion. Even FHA's critics admit that FHA is in no danger of needing additional funding of any type for a couple of years (in a worst case scenario).

I am not suggesting that FHA is "out of woods". No one can dispute the existence of economic risk for FHA today. FHA, like any other holder of mortgage risk, will be affected by continuing house price instability and an unemployment rate hovering around 9 percent. Those concerns are also reflected in the actuarial analysis and are the fundamental reasons why FHA's reserves have fallen in the FY 2011 review.

However, to fulfill its public purpose and counter-cyclical role in the housing market. FHA cannot avoid this economic risk. FHA's challenge is to balance this risk with prudent credit management. I believe the recent performance data demonstrate that FHA is managing this "balance" in a very effective manner.

To summarize, if FHA had not stepped-in and "backstopped" the housing market (particularly home purchases) these past few years, I believe that FHA would be in far worse financial shape today and the Committee would be meeting under even more troubling circumstances for both FHA and the broader housing market.

In this statement, I will first review FHA performance data and then discuss FHA's role in the mortgage market going forward including its relationship with the private mortgage insurance industry.

FHA Loan Performance

FHA's 2009-2011 books comprise over 70% of FHA's portfolio) and are performing at historic low levels of default despite the economic upheaval of the last five years.

To evaluate FHA performance, there are two public early period delinquency measures. They are: 1) Early period delinquency rates provided in the Quarterly Reports to Congress and 2) FHA's Neighborhood Watch system.

- **Early–period delinquency rates**
  (Link to FHA Quarterly Report to Congress – September 30, 2011 http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/rtc/fhartcqtrly p.20)
  - Below is a chart comparing FHA's early period delinquency rates (serious delinquency "within first six required mortgage payments") for 2007-2010 (3Q). (Partial fourth quarter data for 2010 are included to demonstrate the continued improvement.)

Early Period Delinquency Rate
All FHA Loans

Origination Quarter	Early Period Delinquency Rate
▪ 2007 (July-Sep)	2.40%
▪ 2008 (July-Sep)	1.78%
▪ 2009 (July-Sep)	.68%
▪ 2010 (July-Sep)	.39%
▪ 2010 (Oct – Nov)	.30%

The early period delinquency rate has fallen 88% from 2007 to 2010 and has averaged below .4% for originations in the first 11 months of 2010.

- **FHA's Neighborhood Watch System**
  Neighborhood Watch is a public database that was implemented in 1999 and tracks loan performance for loans originated in the most recent two-year periods.

(Link to Neighborhood Watch - https://entp.hud.gov/sfnw/public/)

- The seriously delinquent rate for loans originated in the last two years (October 2009 – September 2011) declined to 1.88%. The seriously delinquent rate had peaked at 5.05% in December 2009 (for loans originated from October 2009 to September 2011). (See Neighborhood Watch quarterly report in Appendix)

- Equally important, the number of seriously delinquent recent originations has also declined significantly. Of the loans originated in the two-year period ending in September 2011, 52,809 mortgages were seriously delinquent, compared to 162,149 loans for the two-year period ending December 2009, a 67 percent decline.

- Only 9 percent of FHA's seriously delinquent loans in its portfolio were originated in the last two years (through September 30, 2011). In December 2009, 30 percent of the seriously delinquent loans in the FHA portfolio were originated in the previous two years.

- To provide some historical context, FHA's seriously delinquent rate for loans originated in the two-year period ending September 30, 2011 is also more than 25 percent lower than the rate for the two-year period ending in June 1999. At that time, the seriously delinquent rate was 2,55 percent.

What are the reasons for FHA's excellent performance?

- **FHA credit quality has improved markedly since 2007.**
  (FHA's Quarterly Report to Congress dated September 30, 2011 – page 7).

  - More borrowers with higher credit scores
    - 35% of FHA borrowers in 2010 and 2011 (first half) had credit scores over 720; 10% of FHA borrowers had credit scores over 720 in 2007.
    - 59% of FHA borrowers in 2010 and 2011 (first half) had credit scores over 680; 19% of FHA borrowers had credit scores over 680 in 2007.

  - Fewer borrowers with lower credit scores
    - 3% of FHA borrowers in 2010 and 2011 (first half) had credit scores under 620; nearly 50% of FHA borrowers had credit scores below 620 in 2007.

FHA credit quality has improved steadily since 2007, 4th quarter. Over 50% of FHA loans made in every quarter since 2009 (2nd quarter) had credit scores above 680. In 2006 and 2007, only about 20% of the FHA loans insured in 2006-2007 had credit scores above 680.

Importance of credit score on FHA loan performance

FHA loans with credit scores above 680 and low downpayments (loan-to-value ratios (LTVs) above 95%) perform better than loans with 10% downpayments and credit scores between 620-679.

Below is an excerpt from FHA's March 2010 testimony before this Committee on the importance of credit scores in the FHA program.

> "Furthermore, downpayment alone is not the only factor that influences loan performance. The combination of downpayment and FICO score is a much better predictor of loan performance than just one of those components alone." (See the chart below.)

FHA Single Family Insured Loan Claim Rates Relative Experience by Loan-to-Value and Credit Score Values Ratios of each Combination's Claim Rate to that of the Lowest Risk Cell				
Loan-to-Value Ratio Ranges	Credit Score Ranges			
	500-579	580-619	620-679	680-8!
Up to 90%	2.6	2.5	**1.9**	1.0
90.1 - 95%	5.9	4.7	3.8	1.7
Above 95%	8.2	5.6	3.5	**1.5**

This chart documents the fact that FHA loans with credit scores over 680 and loan-to-value ratios over 95% perform better than FHA loans with credit scores between 620-679 and LTVs of 90% or less.

- **Seller funded downpayment assistance loans eliminated in FY 2008 were a major cause of FHA's financial issues.**
  - The FY 2011 audit also estimated that SFDPA loans "contribute *negative* $14.12 billion to the economic value of the Fund".
    - FY 2011 economic value would have been over $15 billion and the capital ratio would be almost 2% without seller funded downpayment assistance loans.
  - SFDPA loans outstanding at the end of FY 2011 are now less than 6% of the current portfolio),

- **FHA loan-to-value ratios have declined significantly in recent years.**
    - FHA maximum loan-to-value calculations frequently exceeded 100 percent (often 102-103 percent) in the 1980's and 1990's.
        - Starting in 1983, FHA charged an upfront insurance premium of 3.8 percent that could be financed and closing costs (which depending on the State could exceed 3 percent) could be included in the calculation of the maximum loan amount.
        - Currently the maximum LTV is 96.5 percent and closing costs cannot be financed. The upfront premium is only 1 percent making the maximum LTV only 97.5 percent (with the premium).

- **Lender credit overlays have reduced risk for the Fund**

FHA has been recently criticized for straying from its mission because of the increasing percentage of high credit borrowers in the FHA program. What the critics do not appreciate is that mortgage lenders on their own have tightened guidelines on FHA lending

There are several factors not readily apparent about the FHA program that combine as effective checks and balances on lender actions. The impact is exemplified by the fact that lenders put their own underwriting restrictions (called credit overlays) on top of government restrictions. With credit overlays, lenders in effect are saying they are unwilling to originate certain loans that meet government underwriting criteria.

In late 2007, there was widespread concern that the FHA would become the "dumping ground" for subprime loans and, in fact, FHA did experience deterioration in credit quality at that time. The experiences of three top 10 lenders document this problem. One top 10 lender's average FHA credit score dropped from 634 to 614 in the third quarter of 2007 compared with 2006. Another's average credit score fell to 586 in November 2007. At a third, 22% of borrowers in November 2007 applications had credit scores below 560. In response to this deterioration, mortgage lenders on their own, particularly the large purchasers of FHA loans, tightened underwriting guidelines (e.g. established credit score floors of 620 to 640).

Starting in early 2008, FHA's credit quality began to improve steadily. In actual number of loans, the change is equally significant. In 2007, FHA insured about 150,000 loans with credit scores below 620. In 2010, FHA insured less than 50,000 loans with credit scores below 620 even though FHA activity was approximately four or five times FY 2007 levels.

Why do lenders put credit overlays on loans with 100% government insurance?

Though it may surprise some, the FHA already has its versions of risk retention ("skin in the game") and transparency. First, unlike alternative-A and subprime products, in which the risk was mispriced and the value of the loan was in its "origination" and sale in the secondary market, the ultimate economic value of an FHA loan is in the monthly servicing fee (an annuity-like payment) on a performing loan. In short, long-term loan performance matters in the FHA program.

Since the primary economic value of an FHA loan is the monthly income collected by the servicer, not origination fees, the FHA program, in effect, has a performance-based compensation system. This "deferred compensation," coupled with the consolidation of FHA servicing (five lenders service more than 70% of FHA loans), means that a small group of large financial institutions will have invested an estimated $4 billion this year to buy FHA originations from smaller lenders and mortgage brokers. To protect their investments, these servicers have incentive to monitor originator performance.

And since FHA cannot rely on business self-interest alone to ensure that all lenders act responsibly, it has also developed enforcement tools, including indemnifications (FHA's "repurchases") and, arguably even more important, the public announcement of any FHA sanction. For large public companies, a publicized FHA action brings "headline risk" and unwanted investor scrutiny. For smaller companies, it prompts inquiries from important business partners (warehouse lenders and servicers). In short, reputational risk has always existed in the program and is paramount today because of FHA's higher enforcement focus.

Reputational risk is also on public display in FHA's Neighborhood Watch database that tracks early default and claim loan performance. In addition to targeting FHA audits and sanctioning lenders with high default rates, this database lets business partners, Congress, the press and public examine individual lender performance in any state, city or ZIP code in the country.

Taken together, the "backloading" of loan compensation, reputational risk and transparency strongly influence lender behavior. Put another way, it is in the industry's self-interest to originate well-underwritten FHA loans.

While there is certainly little sympathy for the lender's plight in the housing crisis, I would be remiss if I did not mention that overlays also occur because the industry believes that there has been an overzealous use of sanctions by the government (primarily loan repurchases and now possibly significant penalties for servicing deficiencies). In the industry's view, one of the only ways to combat the government's approach to enforcement is to not make loans with a higher level of risk. (Lender concern is government-wide and not directed specifically at FHA.)

FHA's role in the mortgage market going forward

The good news in the FHA performance numbers is that the borrowers being approved today have the highest credit quality as their remarkably low early-default rates demonstrate. Consequently, our current housing dilemma does not stem from the approval of homebuyers with poor credit characteristics, but rather, from the inability of many creditworthy borrowers to obtain mortgages.

It is no wonder that Federal Reserve Board Chairman Bernanke has been almost pleading for policymakers to take "useful" steps to spur housing and help revitalize the broader economy. The phrase "housing market remained depressed" has been a staple of the Federal Open Market Committee minutes for the last 18 months.

There are too many promising homebuyers being excluded from the housing market. Chairman Bernanke underscored the seriousness of this problem when he said the following in response to a question at his June 2011 press conference:

"... the bottom third of people who might have qualified for a prime mortgage in terms of, say, FICO scores a few years ago cannot qualify today."

This lack of financing is stifling demand and contributing to the weight on home prices and the broader economic recovery. The FOMC minutes from earlier this year detail the problem: "declining house prices remained a drag on household wealth and thus on consumer spending."

As a consequence, the primary threat today to the government housing programs and ultimately the American taxpayer emanate from weak home prices. The current dilemma is epitomized by the concern about the FHA audit. Despite FHA's excellent credit quality and loan performance, the audit (and therefore questions about FHA's solvency) depends heavily on projections about the future house prices.

Rather than looking for ways to lessen the government's role, the immediate focus needs to be on revitalizing a sputtering housing market, dealing with the shadow inventory and avoiding further declines in house prices. The current market should not be held hostage by the poor performance of risky products and poor underwriting of the "bubble" years. They already have done enough damage to millions of American families.

FHA's role & the private mortgage insurers

I believe that the private mortgage insurers should play a vital role in our Nation's housing finance system and it should be expanded. However, their impediment is not the policies of the Federal Housing Administration but rather, the pricing policies of the Government Sponsored Enterprises (GSEs).

FHA has already taken significant steps to facilitate the recovery of the private sector by raising its insurance premiums four times in the last three years. The FHA premium is now in its history and about 60% higher than it was in May 2008. If FHA raised premiums further, it would place another hurdle in the way of future homebuyers at a time when the housing market needs every homebuyer it can find.

The private mortgage insurers' lack of volume is tied directly to the pricing policies of the GSEs. Starting in March 2008, the GSEs added an "adverse market fee" and "loan-level price adjustments" that raised homebuyers' costs for almost all mortgage transactions. For purchase loans with a 95% a loan-to-value ratio, these price increases ranged from 75 basis points to 300 basis points depending on the borrower credit score. On a $200,000 mortgage, this adds $1,500 to $6,000 to the borrower's closing costs.

The principal reason for the difference in costs associated with an FHA loan and a private MI loan is not the cost of mortgage insurance. FHA and private mortgage insurance premiums are roughly comparable depending on the LTV and credit score.

The pricing disparity is the result of the additional GSE fees since Ginnie Mae, the primary secondary market outlet for government loans, only charges a guaranty fee (which the GSEs also charge).

Conclusion

With FHA's book of business growing from $300 billion to over $1 trillion during one of the most challenging economic periods in our country's history, it is a good thing that policy analysts both inside and outside of government are examining FHA's performance and financial stability. However, t is important to remember that these analyses are often based on projections about what might happen rather than what is actually occurring. On the other hand, no one can dispute that FHA loan performance on recent books of business has improved dramatically and is now at historic low levels of default.

Appendix – Neighborhood Watch

All Lenders/Areas - Area Totals
United States Totals
Delinquent Choice - Seriously Delinquent
Performance Period - All Quarter End Dates
Loan Portfolio: 2 Year FHA
Sort Order by Quarter End Dates in Descending Order
Data shown includes all quarter end dates of insured single family loans for the two year period by beginning amortization date

Rank	Area	Quarter End Date	Total Orig.	Total Seriously Delinquent	Total Claims	Total Seriously Delinquent and Claims	% Seriously Delinquent and Claims
1	United States	09/30/2011	2,814,002	49,827	2,982	52,809	1.88
2	United States	06/30/2011	3,060,771	54,698	3,586	58,284	1.90
3	United States	03/31/2011	3,311,056	70,206	4,714	74,920	2.26
4	United States	12/31/2010	3,430,615	90,936	6,017	96,953	2.83
5	United States	09/30/2010	3,442,543	103,198	7,753	110,951	3.22
6	United States	06/30/2010	3,446,807	117,934	8,206	126,140	3.66
7	United States	03/31/2010	3,399,995	142,832	8,978	151,810	4.47
8	United States	12/31/2009	3,212,363	154,190	7,959	162,149	5.05
9	United States	09/30/2009	2,878,599	134,910	7,219	142,129	4.94
10	United States	06/30/2009	2,483,073	105,969	6,144	112,113	4.52
11	United States	03/31/2009	2,105,924	88,002	5,244	93,246	4.43
12	United States	12/31/2008	1,788,355	72,809	4,210	77,019	4.31
13	United States	09/30/2008	1,477,687	50,088	3,508	53,596	3.63

Question from the Honorable Judy Biggert

Q: *Ms. Rosen Wartell, could you clarify for the Committee the language of the 1990 Cranston-Gonzalez National Affordable Housing Act related to FHA?*

A: *In my initial written testimony, I misquoted the text of the Cranston-Gonzalez Act, accidentally referring to a prior version of the legislation and not the version signed into law. Title III, Section 332 of the 1990 Cranston-Gonzalez National Affordable Housing Act states that the MMI Fund shall maintain a capital ratio of at least 2 percent. It also states that when the HUD Secretary determines the fund is not meeting that goal, the Secretary may "propose and implement any adjustments to the insurance premiums." Thank you for the opportunity to correct the record.*

Aggregated industry data indicate that FHA has accounted for most of the primary mortgage insurance issued since 2008 and represented over 60 percent of the insured market in 2011. The data indicate that private mortgage insurers accounted for less than 20 percent of the insured market in 2011 but experienced modest gains in market share over the last two years. Additional analysis of more detailed data would be needed to examine the specific roles of FHA and private mortgage insurers in the higher end of the housing market.