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OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION: EXAMINING HUD'S RESPONSE TO FISCAL CHALLENGES

HEARING

BEFORE THE

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

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING HUD'S RESPONSE TO FISCAL CHALLENGES

DECEMBER 6, 2012

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OVERSIGHT OF THE FEDERAL HOUSING ADMINISTRATION: EXAMINING HUD'S RESPONSE TO FISCAL CHALLENGES

THURSDAY, DECEMBER 6, 2012

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

The Committee met at 10:06 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order. Thank you for joining us, Mr. Secretary.

I asked you to testify today because I am deeply concerned about the recent report that the FHA could potentially need taxpayer support for the first time in its 78-year history. I would like you to help the Committee gain greater insight into the fiscal challenges at the FHA and what HUD has done and can do to mitigate losses and address the shortfall in the capital reserve ratio.

FHA has been helping stabilize the mortgage market by ensuring that qualified low- to moderate-income and first time home buyers have access to mortgage credit since 1934. Since the beginning of the financial crisis, the FHA has increased its market share from below 5 percent in 2006 to about 30 percent at its peak volume in 2009 in pursuit of that mission. This countercyclical expansion was essential to the mortgage market, especially for first-time home buyers who comprised 78 percent of single-family purchase loans insured by FHA in 2011.

FHA's multifamily and health care insurance programs have also played an important countercyclical role since the financial crisis, with a fourfold increase in volume from 2008 to 2011. According to Mark Zandi, chief economist at Moody's Analytics, without the FHA's countercyclical support, and I quote, "the housing market would have cratered, taking the economy with it."

However, providing a backstop for mortgage credit when private sources flee from the market has a cost. The losses at the FHA stem from the now prohibited seller-funded downpayment program, heavy losses in the reverse mortgage program, and loans made at the height of the crisis to prevent a cratering of the housing market. While HUD has already taken some actions to prevent the Mutual Mortgage Insurance Fund for single-family loans from seeking

Federal funds, the Fiscal Year 2012 Actuarial Report suggests that much more needs to be done to prevent such a draw.

I want to hear more today about the administration's actions and proposals to manage the risks to taxpayers stemming from the older books of business and what safeguards are in place to ensure the quality and sustainability of the new books going forward.

If the administration's actions and proposals will not be sufficient to restore FHA's fiscal health, then I plan to work with my colleagues on both sides of the aisle on the Banking Committee to find a bipartisan way to make that happen.

Before I turn to Ranking Member Shelby, I want to recognize his work as Ranking Member on this Committee over the past 6 years. This may be our last hearing together this year, and we will have a new Ranking Member next year. I am proud of our bipartisan record over the last 2 years. We continued the tradition of bipartisanship that this Committee has been known for by passing four significant bills together this Congress, and I thank Senator Shelby for his service.

With that, I turn to Ranking Member Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman.

First of all, I appreciate your remarks. I have been on this Committee 26 years, ending it, but I am not ending being on. I will just have to move down a notch as I go over hopefully to be the Ranking on Appropriations. I will not be far away, and I will not be far from the Secretary on HUD stuff either over there.

[Laughter.]

Senator SHELBY. But I enjoy working with this Committee. I have enjoyed being Chairman of this Committee in two Congresses. The people on this Committee are superb. The staff is superb. And this is a very important Committee not only for the Senate but for the American people and perhaps the world, as most people know, people who are active on this Committee, because banking and housing and everything that goes with it goes right to the heart of what ticks in America: job creation, availability of money, the regulation of our banks, the Securities and Exchange Commission, money laundering, sanctions on Iran. You name it. Most of it, this is the active Committee. So I will be around right near here, but I will be yielding, moving down one notch next to Senator Crapo, and he will do well.

Having said that, welcome again, Mr. Secretary. Just days after the President's reelection, the FHA released its 2012 Actuarial Report which revealed that the economic value of the FHA Fund has fallen to negative $16 billion. A lot of money. That means the fund's capital reserve ratio, as I understand it, now stands at a negative 1.44 percent.

This news is obviously very disturbing to us and to the Secretary, for those of us who have long been concerned about the health of the FHA. For years, the problems of the Federal Housing Administration have been well known. During the housing boom, the FHA, unwisely I thought, guaranteed millions of risky mortgages with low downpayments to borrowers with poor credit scores. We are

reaping that now. These mortgages have resulted in billions of losses to the FHA.

The Federal Housing Administration has made matters worse, I think, by failing to come to grips with the magnitude, Mr. Secretary, of the problems. Back in 2007, as the Federal Housing Administration's poor financial position was becoming clear to all, including right here in this Committee, I urged the FHA to devise a credible plan to improve its finances. I stated then, and I will quote, that "before the taxpayers are faced with greater losses, I believe we must determine how the FHA got into this position, Mr. Secretary, and how it intends to get out."

Unfortunately, for the past 5 years, the FHA's leadership has understated their problems and sought to kick the can down the road. This is now the fourth year in a row that the FHA Fund has been below its statutory minimum capital levels. Yet each year we are told that this is a temporary dip and that within a few years everything will be fine.

In fact, in 2009, Mr. Secretary, you told this Committee that the drop in the capital ratio was expected to be "temporary," and that it would "return above 2 percent within the next 2 or 3 years, even if FHA were to make no policy changes at all."

We now know this forecast was way off the mark. The administration, however, continued to be optimistic. In 2011, for example, HUD still had its projections showing the FHA's capital ratio reaching 2 percent in 2014. Now, despite all these reassurances, the Actuarial Report projects that the FHA Fund has a capital reserve, as I mentioned earlier, of a negative 1.44 percent. And what is the response of the FHA's leadership here?

Just this year, after further declines in the FHA Fund, both Secretary Donovan and Acting FHA Commissioner Carol Galante testified to two different Senate Committees that the fund would "return to the congressionally mandated capital reserve ratio of 2 percent by 2015."

Needless to say, I am not nearly as optimistic about the future of the FHA. I hope it works. I hope it does.

The inability of FHA's leadership to clearly recognize and address its problems is raising doubts, Mr. Secretary, about their credibility and their willingness to properly manage FHA's financing. I think it is time for FHA to face facts. We have to.

First, the capital reserve ratio, the Federal Housing Administration Fund, is dangerously low. You know that. And it has shrunk nearly every year since 2006.

Second, the fund's capital ratios have been below FHA's statutory obligations every year since 2008.

Third, every year since then, future growth in the capital ratio has underperformed in relation to FHA's predictions. Hopefully, the shock produced by these latest projections will finally be a wake-up call for everyone. Hard choices lie ahead for this program. We have talked about this.

FHA leadership, I believe, must fully realize its existing authority to shore up the value of this fund. Additionally, Congress must consider reductions in permissible risk layering and further underwriting reforms and a reexamination of premium structures. It is

time, I believe, to get serious reform of FHA before it needs a taxpayer bailout, if it is not too late already.

I wish you well, Mr. Secretary, but you have a real challenge here. We do with you.

Thank you.

Chairman JOHNSON. Thank you, Senator Shelby.

Are there any other Members who wish to make a brief opening statement? Senator Vitter.

STATEMENT OF SENATOR DAVID VITTER

Senator VITTER. Thanks, Mr. Chairman. Just briefly, I want to agree with the comments of our Ranking Member, Mr. Shelby. And our general concern is that we have seen this coming for a while. We have been talking about it, and the response from the administration has been very modest. Unfortunately, our worst fears are coming true, and even today I am very concerned that the response even given this news is just way too modest.

In discussing last year's Actuarial Report, the Acting Commissioner, Carol Galante, said there is no evidence or widespread prediction that home prices are going to decline to the kind of levels that would require a bailout. Yet right now the question is quickly becoming not if but when. And, still, even in the Secretary's testimony today, we are only talking about things like waiting until the second quarter of next year to raise premiums and then buy ten basis points.

So I would really urge the Secretary and others to consider other more aggressive, more proactive measures. Even the *Washington Post,* which is not exactly a right-wing think tank, said recently, "Right now the critics are starting to look pretty prescient. Affordable possession of one's own home is the American dream. Government support for excessive borrowing has turned into a national nightmare." And the focus of that editorial was we still have not fundamentally reformed that, including at FHA. So I hope we start getting on that track starting today.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Mr. Chairman, thank you very much, and I will be brief. I look forward to hearing the Secretary's response on how FHA balances the goals of remaining self-sufficient without taxpayer funds, but also helping what is still a fragile housing market and ensuring that first-time home buyers can get credit.

There is a clear case to be made, in my mind, that but for FHA in the midst of this housing crisis we would have a far greater crisis on our hands. And so reconciling the fiduciary responsibilities here to the taxpayers as well as the mission to people of America is incredibly important, and I look forward to hearing that.

And with your indulgence, Mr. Chairman, when it comes to my time to question, while I certainly care about FHA, I have an even more pressing issue in the State of New Jersey after thousands of homes were lost, lives were lost, and we are facing the greatest devastation the State has ever had. The Secretary has been charged by the President in that regard to be the—I call it "czar,"

but whatever the appropriate title is, and I will have some questions in that regard on behalf of my State.

Thank you.

Chairman JOHNSON. Thank you all.

I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I would like to briefly introduce our witness. The Honorable Shaun Donovan is the 15th Secretary of Housing and Urban Development. This is his ninth time before the full Committee.

Secretary Donovan, you may proceed with your testimony.

STATEMENT OF SHAUN DONOVAN, SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. DONOVAN. Mr. Chairman, thank you, Ranking Member Shelby, and Members of the Committee. Thank you for the opportunity to testify today regarding the status of the Federal Housing Administration's mortgage insurance programs. I, too, want to add my thanks to Ranking Member Shelby for his leadership and partnership on so many issues these last few years.

This is an important moment for our housing market and our Nation's economic recovery. As 2012 draws to a close, there are encouraging signs: housing construction growing faster than at any time since 2008, the strongest year of home sales since the economic crisis began, and rising home values lifting 1.3 million families above water in the first half of the year alone.

FHA's programs have been a critical component of this economic recovery. That should come as no surprise given the programs' goals and history. With the dual mission of providing access to home ownership for underserved, low-wealth populations and critical financing for multifamily developments, nursing homes, assisted living properties, and hospitals, the FHA is designed to fill gaps in the market, meet important community needs, and act as a stabilizing force during economic distress.

It is clear that FHA has done just that. By ensuring much needed liquidity in the Nation's mortgage finance markets, FHA was a vital, stabilizing force as we experienced the worst economic decline since the Great Depression.

In the last 4 years, the FHA has made home ownership possible for over 3.5 million families, including 2.8 million first-time buyers and for 50 percent of all African American and Latino home buyers last year. While FHA has acted as a critical support, it has not been immune to the stresses of falling home values and rising unemployment of the recession. According to the independent actuary's annual report on the MMI Fund, this fiscal year the capital reserve ratio fellow below zero to negative 1.44 percent, representing a value of negative $16.3 billion.

We take and I take these findings extremely seriously. As stewards of taxpayer dollars, we have, since the start of this administration, made it a priority to strengthen the fund, and we are continuing to take aggressive action to return the fund to fiscal health, including those measures just announced in our annual report to Congress.

It is important for me to start by highlighting several key points that put the actuary's report in perspective. Fully $70 billion in claims are attributable just to the 2007–09 books of business. These 3 years are the major source of stress to the fund. In fact, in its report, the actuary attests to the high quality and significant profitability of the books insured since 2010, the strongest in the agency's history.

It is important to understand this report does not in and of itself mean that it will be necessary for the FHA to use its authority to draw from the Treasury to cover projected losses. While this possibility obviously exists, it is dependent on several factors.

First, that determination would be made using the assumptions in the President's budget to be released in February, not the assumptions used in the actuary's report.

Second, we expect that the new books of business generated after 2012 will create approximately $11 billion in economic value, further strengthening the MMI Fund.

Third, since the Actuarial Report is a point-in-time snapshot, it does not take into account changes FHA recently has announced to address the health of the fund. The final accounting of any shortfall would be done at the end of fiscal year 2013 in order to determine whether funds from the Treasury are necessary.

I would also like to address the primary drivers of the decline in the capital reserve ratio as compared to last year's projections.

First, the house price appreciation estimates used by the actuary for this review were significantly lower than those used last year. That may seem counterintuitive given the economic progress we have seen, but the actual turnaround in the market occurred later than was projected in last year's forecast. In addition, for technical reasons, the forecast is also somewhat artificially dampened by the significant increase in refinancing activity in the market this year.

Second, the continued decline in interest rates, while good for the overall economy, impacts the actuary's model by indicating marginally higher defaults as well as lost revenue to FHA as its borrowers pay off their mortgages to refinance at lower rates.

Third, based on recommendations made by the GAO and HUD's IG and at the direction of FHA, in this year's report the actuary changed the way it reflects losses from defaulted loans and reverse mortgages in the economic value of the MMI Fund.

Let me be clear. These are all important factors to consider when explaining the current status of the fund, but they do not minimize the seriousness of this report in any way. As I said at the outset, we have already taken significant actions to protect and strengthen the fund, including premium increases and changes to credit policy, such as increasing downpayments for lower credit score borrowers and ending seller-financed downpayment assistance. With your help, our efforts have added well over $32 billion to the fund.

The measures I will outline today further address the primary source of the problem: losses stemming from legacy books of business, particularly those insured during the 2007–09 period, and are designed to reduce our loss severities by at least 5 percent, generating approximately $3 billion in economic value over the next 2 years.

First, we have announced changes to our Loss Mitigation Program that targets deeper levels of relief for struggling borrowers to more effectively assist families in meeting their obligations and avoid costly foreclosures for FHA. Similarly, we are streamlining the use of short sales and aligning our practices with those recently announced by the GSEs to provide more families the opportunity to avoid foreclosure while reducing costs for the FHA. And we have dramatically increased the use of alternative dispositions for defaulted loans, including our new Distressed Asset Stabilization Program. The improvement in recoveries to FHA from this program is estimated at over $1 billion this year alone.

We are also taking proactive measures on new loans. In particular, we are reversing a policy change made over a decade ago that allowed borrowers to stop paying premiums after their loans reached a certain loan-to-value ratio. This change left the FHA without premiums to cover the losses on loans held beyond the period for which those premiums were collected, reversing the policies expected to improve the value of the fund by $2.6 billion in this fiscal year alone.

In addition, we will raise our annual mortgage insurance premiums by 10 basis points. We estimate this will increase costs to new borrowers by about $13 per month, but it will also further reduce our footprint in the market while adding an estimated $1 billion of additional economic value to the fund this year.

As private capital returns, FHA must continue to balance pricing to ensure that it occupies a smaller, healthier share of the market. In fact, FHA's market share has been declining since 2009, and 2012 represents our lowest-volume year since the start of the economic crisis.

While I focused today on FHA's single-family programs, I wanted to take the opportunity to reassure the Committee that our efforts to protect our insurance funds span the range of our programs. We have already raised our mortgage insurance premiums on multifamily and health care loans and instituted other risk management reforms, such as special reviews for large loans, post-commitment reviews by credit risk officers, and an active loan committee process.

Even as we use our existing authority to take these aggressive measures to protect the fund, other actions require your partnership. In addition to the increased indemnification authority and broader geographical enforcement powers recently passed by the House, we have a number of proposals designed to place FHA in a stronger fiscal position over the next 12 months and beyond, including new loss mitigation authority, additional enforcement authority, and greater administrative flexibility in managing the reverse mortgage program.

The house has recently passed important bipartisan FHA reform legislation, and we look forward to continuing to work with both chambers to create the tools we need to strengthen the program, meet its mission, and place the MMI Fund back on firm footing. I encourage the Senate to engage in discussions that build on this progress in the House in order to achieve a consensus that will give FHA these tools as quickly as possible.

There are no guarantees that the actions I have described will prevent FHA from tapping into the Treasury next September. However, swift action from Congress, coupled with the $11 billion in additional value from the new fiscal year 2013 business, will reduce the likelihood that a Treasury draw will be necessary.

Furthermore, these changes, as well as those we have made over the past 4 years, have laid the foundation for a stronger FHA and a healthier MMI Fund that supports the recovery of the housing market and economy while actively reducing FHA's market share.

As we work together to adapt and reform the FHA program, we must proceed with a balanced approach that recognizes both the challenges to FHA and its contributions to our economy. We are eager to work with you to achieve these shared goals.

Thank you again for the opportunity to testify today, and I look forward to taking your questions.

Chairman JOHNSON. Thank you for your testimony.

As we begin questions, I will ask the clerk to put 5 minutes on the clock for each Member.

Secretary Donovan, I am very concerned about the FHA's fiscal condition, as detailed by fiscal year 2012 report, particularly the negative capital reserve ratio. What action have you taken to restore FHA's capital reserve and prevent FHA from requesting taxpayer support?

Mr. DONOVAN. Mr. Chairman, the most important actions that we have taken have been in partnership with this Committee, and I would particularly recognize the fact that you passed a ban on seller-funded downpayments, which went into effect and we implemented in 2009. That action alone we believe has saved the FHA fund about $12 billion.

There are additional actions that we have taken. We have raised premiums four times, made underwriting changes that include raising downpayments for the riskiest borrowers. That series of changes has added, we estimate, an additional $20 billion to the value of the fund. Quite simply, if we had not taken those actions in partnership with you, we would find ourselves in a vastly worse position today for the FHA fund.

Chairman JOHNSON. Mr. Secretary, you have detailed several steps that would help stabilize FHA's finances. Given the condition of the FHA's old books of business, why weren't these changes made earlier? Will these changes allow the FHA to outperform projections again this year and avoid drawing funds from the Treasury?

Mr. DONOVAN. As I said in my testimony, I cannot guarantee that we will not need to draw at the end of the fiscal year. What I can say is that I believe we are taking all appropriate steps to try to avoid that, balancing both the health of the fund but also the fragile recovery that we have in the market.

For example, we have already moved to increase premiums for the fifth time. We believe that that is an appropriate step and that it leaves FHA appropriately priced. We would be concerned, however, about going significantly further in raising premiums both because it would have potential negative impacts on the housing market—we are seeing a recovery, but it is still fragile, and we do not

want to hurt the market and in turn hurt the FHA fund by going too far to stop that recovery.

But I would also suggest, as you see in the chart on the right, we are currently—and the independent actuary confirms this, that the new books of business are highly profitable. And so I think there is, beyond the market question, a question of how far do we go in visiting the sins of the past on new borrowers. The premiums that are being paid by new borrowers more than cover the expected losses. We think that is appropriately priced and will help to shrink our market share. But what we need to do is continue to focus on these older books of business, and that is why I have focused, in the changes that we have made, we announced in our report to Congress, on steps that will increase our collections from these older books of business.

Just from the asset sales that we have instituted, and we are going to ramp up going forward, we have increased the returns on these distressed loans by more than 10 percent simply with those steps.

So we need to continue to focus on things, and we have asked for authority from you to take steps that would help increase our returns on the older books of business. We think those are the most appropriate measures that we can take.

Chairman JOHNSON. Secretary Donovan, one of these steps is better loss mitigation by transferring sourcing from servicers who are underperforming. What is preventing FHA from doing that under its existing servicing contracts?

Mr. DONOVAN. Quite simply, we need legislative authority to be able to force those transfers to happen, and that is a critical step. It is something that we have seen in the private market start to increasingly happen. It is something we believe would be very helpful to send a very strong message to those servicers that are underperforming. But it is one of a number of steps that we would ask that you give us legislative attorney for as quickly as possible.

Chairman JOHNSON. One more question. Secretary Donovan, the Actuarial Report's finding of a negative economic value in the MMI Fund is mainly a reflection of problem legacy loans guaranteed during the housing bubble. What steps has FHA taken to improve its underwriting criteria and risk assessments for the new loans?

Mr. DONOVAN. As I mentioned earlier, clearly the steps that you took to ban seller-funded downpayment loans were a critical piece of that. We also looked at the performance of our loans very carefully, and so in addition the premium increases, we did require a 10-percent downpayment for our riskiest borrowers. That we believe was a very important step in changing our underwriting.

We also have taken many other steps on other aspects of underwriting that have to do with what costs can be rolled into the loan, and other steps that reduce the effective risk of those loans that are quite important. Part of that has been able to be done because, quite frankly, we did not have a strong enough risk focus at FHA in the midst of the crisis. We have created a very strong risk management focus through the creation of a chief risk officer for FHA—that has never existed before—as well as building a team of analysts that are really providing data on an ongoing basis on early

payment defaults and a whole range of other information that we simply did not have before in real time.

So it is not only the underwriting changes themselves, it is also the focus on risk and the way that we are measuring it on a real-time basis that has given us new tools.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you, Mr. Chairman.

Secretary Donovan, lead me through this and tell me if I wrong on this, or right, or what. It is my understanding that under the statutes now prevailing, the Federal Housing Administration could, if necessary or you deemed it necessary, tap the Treasury for an endless supply of money. A lot of us would call that a bailout. Do you anticipate that? Can you assure us and the American people today, as the Secretary of HUD, that FHA will not do that? Or you do not know yet?

Mr. DONOVAN. Senator, I wish I had a crystal ball and I could tell you that we will not at the end of the year. Given the Actuarial Report this year, obviously I am highly concerned about that possibility.

Senator SHELBY. Are you getting close?

Mr. DONOVAN. Certainly we are closer than we have been in the past.

Senator SHELBY. And how close are you, honestly?

Mr. DONOVAN. What I will tell you is, again, an independent actuarial report is the best I can give you in terms of that view.

Senator SHELBY. And that is not good, is it?

Mr. DONOVAN. What it says——

Senator SHELBY. The Actuarial Report is not good.

Mr. DONOVAN. It is not. But one important piece of this is that what is required for the actuarial is a review as if we stopped doing business on the date of the actuarial. The important thing that we can do and that we have done to try to avoid taking funds from the Treasury at the end of the year is to look at the revenue we expect this year—that is about $11 billion—and to make changes to underwriting and other steps that would help avoid that.

Senator SHELBY. Does that include upping the premium a little?

Mr. DONOVAN. We have already moved to increase the premium an additional 10 basis points, an average of about $13 a month that we expect from borrowers.

Senator SHELBY. And how much money would that be projecting?

Mr. DONOVAN. That would add about $1 billion just this year alone and much more into the future.

Senator SHELBY. What is the size of your portfolio today, roughly?

Mr. DONOVAN. It is over $1 trillion when you combine——

Senator SHELBY. $1 trillion worth of loans, right?

Mr. DONOVAN. When you combine all of the various programs.

Senator SHELBY. And how close are you as far as working capital, so to speak?

Mr. DONOVAN. It is an important question. Today, even though the Actuarial Report shows a negative balance, we have a cash balance of over $30 billion today, $30.5 billion. And, in fact, one of the things the actuary looks at, assume that we continue to do busi-

ness, assume that we continue to operate, what is the likelihood—which obviously we plan to continue to operate.

Senator SHELBY. Sure.

Mr. DONOVAN. What is the likelihood that we actually—the cash balance goes negative? And the actuarial, despite the worse condition this year, still has a less than 5-percent chance that we actually run through all of those cash reserves going forward.

Senator SHELBY. Give us the worst-case scenario. It is the first week of December now. Say 3 weeks from now, what is your worst-case scenario getting up to the 1st of the year where you might be or not be? What would cause you to have a lot of heartburn say around the 1st of the year?

Mr. DONOVAN. The single greatest issue of concern is where the housing market will go from here. If the housing market continues to recover, as it has this year, that is the most important thing that we can see to restore the fund to health. House price appreciation is the single most important variable in the health of the fund going forward, and that is also why I will say we are so concerned about balancing the steps that we are taking to make sure we are not doing anything that would impede the recovery and come back and harm the FHA in the long run by decreasing the improvement that we see in housing markets.

Senator SHELBY. We all realize that FHA serves a good purpose, but it is just not sound financially. As the Secretary of HUD, shouldn't the fiscal well-being of FHA be one of your highest priorities?

Mr. DONOVAN. Absolutely. Absolutely.

Senator SHELBY. And are you just going to deal with what comes up like you outlined today?

Mr. DONOVAN. I would welcome additional ideas and suggestions that you may have. I certainly feel that there—we will take steps within our power. We would like to work with you, as I have said, as quickly as possible to move additional authorities that would help us do this. But I am also open today or at any time to additional suggestions about what further steps we could take.

Senator SHELBY. If you do tap the Treasury—in other words, there is a bailout, so to speak, if it is a sizable one—how would you pay that money back? Premiums or efficiency or the housing recovery, or all of the above?

Mr. DONOVAN. We certainly believe that we need to keep FHA in a position where our new books of business are producing substantial revenue for the taxpayer. This year alone, we expect our new loans to return a $10 billion profit, if I can use that term, to the taxpayer. That is the way that we need to continue to restore the health of the fund and, should we need to draw on the Treasury, to restore that money to the taxpayer.

Senator SHELBY. Thank you.

Thanks, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman, and thank you, Mr. Secretary.

I would repeat what my colleagues have said. It is very disturbing to have a report that shows 1.4 percent negative equity in

a critical fund, and this is an issue that has not suddenly emerged. It has been growing over several years.

You have indicated that you are taking steps to fix these problems, and many people have said that in the past, too, and, again, can you sort of give us some assurance that this time is different?

Mr. DONOVAN. What I can say, Senator, is that I believe we are taking every responsible measure that we can to improve the health of the fund, while at the same time not hurting the fragile recovery that we have. I do not have a crystal ball, and I believe that we need to continue to take input and guidance on getting a better picture of the fund.

One of the reasons why the fund looks significantly worse this year than it did last year, we got criticism last year from outside experts, from the GAO, from our IG, of the way that we model claims in our actuarial. We went back and directed our actuary to change the way we model, and that change alone subtracted $13 billion from the value of the fund.

So I am not going to sit here and say we have been perfect in the way that we have looked at the fund or that we have modeled it. And one of my responsibilities is to continue to make changes to get as accurate a picture as we possibly can and to take steps based on that.

Senator REED. Let me ask perhaps a related question. As you look forward in terms of the health of the fund, one fact, it would seem to me—and I would assume it would be explicitly in the model—would be an assumption about unemployment rates going forward. What unemployment rate are you assuming over the next year or so? Because it directly affects payment.

Mr. DONOVAN. Absolutely. One of the important changes we made to the model this year, not to get too wonky here, is to go to something that is called "stochastic modeling." One of the criticisms we had is that we—the way the model worked is we chose one path and modeled based on that. State-of-the-art modeling assigns probabilities to a whole different range of paths that the economy might go through. So we have actually modeled a vast range of scenarios.

One of the things we looked at last year, that we directed our actuaries to look at, was to say: What if interest rates go low? What is going to happen to the fund? We ran that last year. That scenario predicted that the fund would go negative. In fact, we have had what is effectively the low interest rate scenario happen this year with QE3, and that has clearly had a substantial impact, roughly a $10 billion negative impact on the fund, just from those interest rates alone. So those are clearly steps that we are taking. We would be happy to share with you the various unemployment rate scenarios that we are looking at and home price paths that we are looking at. But, again, we look at a range of those to get to the best possible prediction.

Senator REED. You got close to watching this with stochastic modeling, but you avoided Bayes' theorem, so you are fine.

One of the problems that you face is this series of years of terribly mispriced loans in 2007 to 2009, and it would seem to me one of the things that you are trying to do is to clear these as quickly as possible. But as you have indicated to us, you need help with

servicing, that you have to do much more aggressive modification sales, and also for the real estate that effectively you own, you have to dispose of it.

Can you comment on how much you think you can achieve in relieving pressure on the fund by doing that, looking back and taking care of that period?

Mr. DONOVAN. We think with a set of changes that we are already taking, that we announced in our report to Congress with the actuarial, that include the loan sales that we have taken, changes to short sales, changes to what we call our loss mitigation waterfall, how we work with borrowers that are in trouble, those alone could add about $3 billion to the fund over the next couple years.

What we need help on is that many of our enforcement authorities—and, again, if you think about how we collect on the bad loans, enforcement is an important piece of that, to say to lenders, you made a bad loan, there was fraud or there was something else involved, we need to hold you accountable for that and bring funding back to the taxpayer. There are a number of provisions that would help us.

One is giving us broader geographic authority. We have some perverse restrictions right now in legislation in terms of the way that we can hold lenders accountable on a narrow geographic basis, what we can do to require indemnification of loans, the standard for fraud. Those are all pieces of what we would want to work with you to get passed very quickly to be able to enhance our enforcement authority. Those as well would likely add billions of dollars to the fund.

As you know, we have been able to recover well over $1 billion just this year in settlements around servicing and originations with many of our biggest lenders.

Senator REED. Thank you very much, Mr. Secretary, and thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. And, Mr. Secretary, thank you for your testimony today. You asked for some suggestions, and I would like to make just a few.

It is my understanding that on the private side right now, FICO scores really at 620 is where the market is. And FHA is at 580, and basically it is creating a situation where the private lenders are being made out to be bad guys because even though your FICO scores are 580, they are not doing anything below 620.

As one of the steps that you might take, would it make sense for you to go ahead and get on up to 620? Right now there is huge demand out there, and at some point that is going to diminish, and then we will drive back down as people try to get market share again. Would it not make sense to go ahead and implement what the market is telling you to do?

Mr. DONOVAN. That is something that we are actually looking at. I think it is likely that we take additional steps as we are working toward the President's budget and understanding in more detail the results of the actuarial. That is clearly something we are looking at.

We are concerned that some of the overlays that lenders are putting on go farther than are necessary. In other words, we do believe that there has been an overcorrection, if you will, in some parts of the market where we have what are very safe borrowers that are having a hard time accessing credit. But I also agree that we need to be looking at and perhaps adjusting on the FICO side as well.

Senator CORKER. And, generally, for what it is worth—I appreciate your testimony today. I know we have had discussions about that sometimes in the past, and I do realize you had a lot of bad loans on the books that you inherited. I do think there are things you can do now to really cause the fund to be far more sound, and I do think you all are being a little slow in moving that way.

And so a second one I would move to is reverse mortgages. I mean, you are losing your shirt on reverse mortgages. Losing your shirt. It is a small part of what you are doing, and yet you have got mortgage brokers out there that are making an absolute fortune right now—a fortune. Some of them are good operators. A lot of them are schlocky operators. And I do not understand why you do not shut the program down for 24 months, as I know has been suggested to you. Why don't you do that?

Mr. DONOVAN. Once again, Senator, you have hit on an issue that is an important one and that we do believe we need to make changes on.

Senator CORKER. But why don't you just do it?

Mr. DONOVAN. Well, frankly, we did make changes. We introduced a much safer—better, we thought—alternative through our SAVER program. We could effectively do what you said, which is to just create a moratorium on the other program. What we are concerned about is, particularly given the economic crisis that seniors are going to—have gone through, that we would be eliminating an option that works for some seniors if it is done safely in order to eliminate also the bad loans that are being made.

Our preference, if we could get the authority from you to change the structure of the program to make it much more effective and safe, that would be a better way to go. If we cannot get that authority quickly, we will have to look at——

Senator CORKER. I mean, I would think—why can't we do a unanimous consent? It seems to me that most people would be willing to do that.

Mr. DONOVAN. Let us talk about that today. I would love to——

Senator CORKER. I know you have got a partial situation that has been very healthy, and it seems to me if you are worried about seniors, you could keep the ability to draw down a partial amount, which is very safe, and you would eliminate—and you could do that all by yourself, and we could worry about the legislation whenever it is time. I am willing to look at it now, but just for what it is worth, it does feel like there is a lot you could do to make FHA healthy today that is not being done. But let us talk further, OK?

Loan limits. It seems like right now—I mean, Fannie and Freddie are down at, I think, 625. You are still up at 729. Wouldn't it make sense to go ahead now and make some changes that need to be made? I mean, you can do that yourself. Why don't we do that?

Mr. DONOVAN. We, as I think you know, supported our loan limits coming down, and they were supposed to expire last year. Congress made the decision to lower the GSEs' loan limits, but kept FHA's——

Senator CORKER. Can you self-implement that, though? You cannot do that without——

Mr. DONOVAN. I do not believe, given that Congress explicitly extended those higher limits, that we can take that step and——

Senator CORKER. Would you like for us to help you do that?

Mr. DONOVAN. We have supported before and I will state again today that going back to the pre-HERA limits makes real sense, and I will go further than that, that we should lay out a path to go back to even lower limits that existed before the crisis in a way that is done consistent with how we do housing finance reform. That is a larger question, but the immediate step of going back to the pre-HERA limits is one that we would support.

Senator CORKER. Well, you are developing a fan, and I hope that we can look at some of those things.

Home mortgage insurance. The way I understand that it works is private mortgage insurers, when you get down to a certain loan-to-value ratio, the premium is dropped, but also the insurance is dropped. And yet you have a $1 trillion in loans on your books where the loan-to-value has dropped, they are no longer paying premiums, but you are keeping the guarantee in place. That does not make any sense to me. Why don't you continue to make the homeowner who has that guarantee continue to make the premium payments? That would be something that, it seems to me, would be extremely helpful to you during this difficult time.

Mr. DONOVAN. Once again, an excellent suggestion. We announced with our report to Congress that we are doing that for new loans. Unfortunately——

Senator CORKER. But why not the trillion that are on the books?

Mr. DONOVAN. Unfortunately, we cannot go back and modify a contract. When that homeowner took that loan, they signed a deal with FHA that said this is the way the premium structure would work. We looked at this. We fully analyzed it. We cannot break those contracts, unfortunately. And so it is something that we're going to need to implement.

I will say, however, that the value of doing it now in a low interest rate environment is substantially larger on these new loans, for two reasons: the lower the interest rate, the faster the amortization of the principal, and, therefore, this will be a more valuable change; second, because these loans are so low interest rate, they will be on our books far larger. So, frankly, not many loans in the past have hit that limit. So even though it is a $1 trillion portfolio, the value of that change is quite small for the old loans. It is really going to be quite valuable for these newer very low interest rate loans.

Senator CORKER. Mr. Chairman, I made no opening statement. Briefly, two more questions.

I see that FHA is now making loans to people who 3 years ago were foreclosed upon, and that is a very different standard than even exists at Fannie and Freddie. I do not understand. Why are you doing that?

Mr. DONOVAN. This is another area where we are working on changes, and here is the issue: We have a significant number of homeowners that were responsible homeowners, had good credit scores, that lost their jobs in the biggest economic crisis this country has faced since the Depression. And we believe if somebody can show that they are back at work and are a responsible borrower again, that is somebody that we ought to work with.

I would agree that our standards are not clear enough in dividing those, so what we believe we need to do is clarify those standards, but not necessarily eliminate the possibility that somebody who has done the right thing and through no fault of their own lost a job but can now be a responsible homeowner again has the chance.

So my view would be it is not just the 3-year limit that is important. It is: What are the criteria that we set for how somebody reestablishes their credit and being a responsible homeowner? That is where I would propose we work together.

Senator CORKER. OK. My last question, and thank you for your patience. First of all, it sounds like there are a lot of things that could be done right now to solve a lot of problems, and I hope that we as a Committee will figure out a way to work with you on those things we need to work with you on, but that you will do the things you can do on your own now.

You and I had a pretty long conversation several months ago when Carol Galante had the opportunity, candidly, to assume her post on a permanent basis, and we could not get the Administration to agree to not air-drop something and bypass the Committee. It was an unfortunate circumstance. But I guess, as I look at it, I would just ask you the question: Did we dodge a bullet in appointing her full-time with all the issues that we have at FHA? And does she really have the ability to press the Administration to overcome political issues to actually cause the fund itself to be actuarially sound? Because it appears to me that we are still not quite doing the things we ought to do to make the fund operate. And it seems to me that maybe there is a little political pressure, and maybe she is not strong enough to make that happen.

Mr. DONOVAN. Senator, here are the facts as I see them: We have taken the most aggressive steps I think in the history of the agency to make sure the new business that we are doing is strong. If you look at that chart right there, what you will see is huge profitability relative to the history for the new loans that we are making. We have only so much that we can do to fix the problems of those older loans.

So I agree with you on many of the steps that you describe today. What we should not imagine is that somehow taking those steps can take us from the difficult financial condition that we find the FHA in today, somehow eliminating what has been an enormous trauma in the housing market.

I have enormous confidence that Carol can and will lead us on the path that we need to take. And, in fact, you do not have to take my word for it. I think the evidence of the changes that we have made, the steps that we took—you remember last year the President's budget thought that we might need a draw at the end of last year. Carol took aggressive steps on enforcement, on changes to un-

derwriting that meant instead of close to a negative $1 billion balance, we ended the year with a more than $3 billion positive balance.

Those were aggressive steps that she took. I listened to her, but she took those. And I believe that that is the kind of leadership that can help us continue down this path.

Senator CORKER. Thank you.

Chairman JOHNSON. Senator Hagan.

Senator HAGAN. Thank you, Mr. Chairman. And, Mr. Secretary, thanks for your testimony today.

I know that Senator Corker asked about reverse mortgages, and I am concerned about that issue. And I am particularly concerned that $2.8 billion of the $16 billion economic shortfall are related to that program.

Can you talk a little bit more about why these losses under the reverse mortgage program are so severe?

Mr. DONOVAN. Here is the fundamental problem, without getting into too much of the history. At one point when Fannie Mae was issuing these loans, they were generally variable rate, and they allowed a borrower to basically draw on, you know, over time the amount of money that they needed.

As that program has switched to being a Ginnie Mae program, there is basically no option for those borrowers to do anything but draw the full amount.

Senator HAGAN. And why?

Mr. DONOVAN. Because we do not have the statutory authority to be able to make the changes to the program that would allow us to limit the draw up front. That is the change that we are asking that be made.

Our alternative—and I was just discussing it with Senator Corker—we could basically eliminate or put a moratorium on our regular program and just go to what we call our SAVER program, which is somewhat safer. But the problem is we still do not have the authority even under that program to avoid this full-draw feature of it.

So the right answer, in our view, is: Give us the authority to make the changes we need so that we end up with what is a safer product for FHA and, frankly, a safer and better product for seniors. What we are finding is with this full-draw product, too many seniors end up in situations where they cannot cover their insurance and their taxes, and too often we lead to a situation where they have more leverage, more debt than their home is worth by the time they are ready to sell that home.

Senator HAGAN. And so you are saying because of that change, there is what resulted in the $2.9 billion?

Mr. DONOVAN. That is for many of these—for most of the new loans that we are making, they are at this full draw, and the actuary predicts there are going to be enormous losses on those going forward because of this full-draw feature.

Senator HAGAN. OK. And, also, the last time you testified before the Committee, we discussed the National Mortgage Settlement. Can you talk briefly about the MMI Fund, how it has benefited from the settlement?

Mr. DONOVAN. In the most direct way, it has benefited by well over $1 billion that came directly to the fund from that settlement or that series of settlements. Also important, though, is we put in place, not just for FHA loans but for every kind of loan serviced by the five banks that were part of it that control 60 percent of all servicing, new standards for how they foreclose on loans, how they work with troubled borrowers, and in the long run those changes will have very important effects not just for homeowners and communities but also benefits to the FHA fund, because we will have fewer foreclosures and better recoveries on the loans, whether it is through short sales or keeping homeowners in their homes.

Senator HAGAN. The settlement also includes billions of dollars in debt forgiveness for the borrowers, and generally the discharge of indebtedness is taxable to borrowers, but certain exceptions exist for indebtedness related to principal residences. This exception is set to the expire at the end of this year.

What is the interplay of the expiring tax provision and principal reduced from borrowers? And how would the expiration of that provision impact participation in the settlement and the relief that borrowers see now?

Mr. DONOVAN. Well, it would be a cruel irony if homeowners have the ability to stay in their homes because of a principal reduction that is both good for them and their lender because it is going to lower the losses on that loan in the long term, only to get, come tax time, a giant tax bill for that principal reduction, which drives them back into delinquency and potentially foreclosure.

And so the President has made it a real priority to try to get that provision into whatever tax extenders we may do at the end of this year, and it is a very high priority for us among the many things that will be at issue in that tax extender.

Senator HAGAN. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

Again, as I said at the beginning, I have the real concern that I think is shared by a lot of Committee Members that the changes in reforms FHA has made and you are talking about today are not significant enough given the looming threat. And you say they are unprecedented. Both of those things could still be true. They could be more than ever before, and still not enough given the magnitude of what we are talking about. And that is the concern.

First of all, let us talk about the clear potential now for a taxpayer bailout. Is it not right that under the Federal Credit Reform Act it would allow the Treasury to make necessary cash or credit transfers to FHA in order for them to continue making payments sort of automatically?

Mr. DONOVAN. That is absolutely correct. That is the way not only FHA but other similar programs are designed.

Senator VITTER. That is obviously significant for the taxpayer. We all care about that. Can you commit to us that you will keep us and the Congress fully apprised of your moving projections with regard to that, and certainly fully apprised when that happens?

Mr. DONOVAN. I am absolutely committed to make sure that if we are going to take that step, you would be fully notified.

Senator VITTER. Well, my question was a little more than that. It was to keep us fully apprised of your current and updated projections toward that issue. Can you commit to us to give us that information, your best projections today and whenever that changes, and certainly if that is going to happen?

Mr. DONOVAN. I do. And, Senator, what I would suggest—we do provide a monthly report to Congress on the status of the fund. If there is additional information or somewhat different information that would be useful to you in that, we are very happy to work with you on that.

Senator VITTER. OK. Well, what I am talking about is, as of today, when do you project there is going to have to be a taxpayer-funded bailout? What is your best projection?

Mr. DONOVAN. What I would say is our best projection will be contained in the President's budget. We are still working on the underlying economic assumptions that go into that. And so I do not have anything beyond what the actuary did that would be a different prediction today.

Senator VITTER. So today, within all of HUD and all of FHA, you have no best guess about that?

Mr. DONOVAN. I am not sure what you would suggest is a best guess other than to say the Actuarial Report has a value of the fund as of the date it was performed. In addition to that, we expect about $11 billion of new revenue, and the changes that we have implemented we believe will bring billions of dollars of additional revenue to the——

Senator VITTER. Based on all of that, do you expect a taxpayer bailout, as we sit here today? If so, when?

Mr. DONOVAN. Based on those steps, I believe we have significantly decreased the chance of having a bailout at the end of 2013 or having to draw on the Treasury. I am not going to assign a probability at this point because we are still working on the assumptions and other steps in the budget, and I will be able to give you a number when we have completed the budget projections.

Senator VITTER. OK. Well, again, I want to re-ask for your best information about that as it develops, and, unfortunately, we do not have that today. I think you all have some idea, some best guess. You are not giving it to us. We would really like that as soon as you can give it to us and from then on, on an updated basis.

With regard to changes that are being made, you just said they are unprecedented and the proof is in the pudding and the changes that Ms. Galante made in the last year stepped us back from that possibility. I just want to add for the record, there was another big factor. The $1 billion in the AG settlement—that was just found money—was a huge factor that had nothing to do with reforms or changes.

But I also want to associate myself with Senator Corker's suggestions about a whole menu of things that we believe exist that you all are not doing that I believe is warranted. There are several ways—and Senator Corker touched on this—that FHA has much laxer standards than Fannie and Freddie. And as a result, you are creating a huge magnet to draw the worst problem loans to FHA because of that. One of those is maximum loan limit, and another

is the issue he brought up of allowing a borrower to reborrow 3 years after a foreclosure. Fannie and Freddie, that is 4 to 7 years.

On those two things and anything else like that, why wouldn't you align FHA with Fannie and Freddie to stop this negative selection that is occurring toward FHA?

Mr. DONOVAN. Senator, two things I would just say.

One is it is not accurate to say that the reason the fund remained positive last year was because of the settlement. The value at the end of the year was over $3 billion. If the settlement had not happened, we still would have been positive.

And the second thing I would say is I do not see the settlement as unrelated to policy changes. Strong enforcement is part of what we need to do to make sure that we hold lenders accountable and that we minimize losses from those older books of business which are causing the stress to the fund.

And so I believe very strongly it was the right policy decision. It is related to steps that we have taken. And even if it had not happened, we would have remained positive last year.

So on loan limits, as I said before, we do not have the authority without Congress acting. The administration advocated that loan limits come down. I thought it was, frankly, perverse to bring Fannie and Freddie's loan limits down and not to lower FHA's at the same time, exactly for the reasons that you have said. We are concerned that it would drive business to FHA that should go back to the private market.

So I would urge you and others—I know you are supportive, but to work with your colleagues to try to do that as quickly as possible. And I do agree that we need to look at—and we are doing that, looking at the standards for how we allow borrowers who may have defaulted in the past to borrow. Again, I would say, though, we should not hold a responsible homeowner who has demonstrated their ability to pay back their debts and to be a homeowner, a successful homeowner, simply because they may have lost a job due to what is an unprecedented economic crisis that we have been through.

So this is not just about timelines. It is about what the standards are for when we allow folks to borrow.

Senator VITTER. Well, my broader point is this and several other factors should also be about doing it in a way that you are aware of what competing opportunities' rules are, like Fannie and Freddie. And if FHA has laxer standards, I mean, clearly you are going to encourage the accumulation of weaker loans. I think that is obvious.

Mr. DONOVAN. Yes, I agree with you. One of the things that we announced just a few weeks ago with the Actuarial Report is that we are implementing standards on short sales that are aligned with what Fannie and Freddie are doing. So we are looking for opportunities wherever we can to try to align those standards. That does not mean on everything that we should be identical to them, but aligning where appropriate makes great sense.

Senator VITTER. And as I understand it, another significant factor in terms of potential loss is the whole reverse mortgage program, which is projected to be a drain on the system even in the best economic circumstances. And as I understand it, FHA has the

authority to suspend that program. It is a huge profit center for folks who participate in the private sector. It is costing the taxpayer money essentially, or threatening exposure in the best of times. Why wouldn't we suspend that tomorrow?

Mr. DONOVAN. That is an option that we are clearly looking at. We believe there is a better option, which would be to get legislative reform to allow us to implement a better product. That is something, as I talked about with Senator Corker, we would love to work with you on the next few weeks. The House has passed an FHA reform bill. We would love to be able to do something even in this session of Congress before the Ranking Member leaves. That is area——

Senator VITTER. Well, let me——

Chairman JOHNSON. Senator Vitter, please begin to wrap it up.

Senator VITTER. Sure. I will wrap it up very quickly.

Let me suggest melding those two ideas together. I think if you suspend that program tomorrow, you will start saving the taxpayer money and create more pressure for the reform you are describing.

Thank you.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Secretary, while I clearly have questions about Sandy, let me just create some balance here from my perspective.

First of all, am I wrong to say that the HUD report says that FHA continues to be impacted by losses from mortgages originated prior to 2009?

Mr. DONOVAN. That is exactly right, and, Senator, if you look at the chart, on the right here, what you see is that through 2007 and 2008 in particular are huge costs to the fund that in 2009 we saw still negative impact but real improvement, and then in 2010 through 2012, those loans are expected to contribute substantial revenues to the fund and to the taxpayer.

Senator MENENDEZ. So a good part of the portfolio that we have been suffering with here certainly took place prior to this administration.

Mr. DONOVAN. That is correct. But I would also give you all credit for acting to end seller-funded downpayment at the end of 2008, which we implemented in 2009.

Senator MENENDEZ. Now, I know there is some talk about the higher loan limits and your own view, but let me just say, Doesn't the audit also say that "larger loans tend to perform better compared with smaller loans in the same geographical area, all else being equal"?

Mr. DONOVAN. Our early data is that these larger loans are performing somewhat better. We do believe, however, it is too early to make any final conclusions about it simply because these loans have not had much time to season at this point.

Senator MENENDEZ. Well, it seems to me that so far they have probably strengthened FHA's balance sheet by allowing larger, better performing loans. And there is a problem here. There are parts of the country in which those lower loan limits would make FHA virtually non as valuable to its core mission as it would in other parts of the country, which is why on a bipartisan basis we passed preserving the higher loan limits. So I am looking forward to see-

ing the continuing performance of them because I think it would make another case. And I am waiting for the private sector to come in. I mean, I keep hearing about the private sector ready to come in, but it just does not seem to be happening.

Now, there are some who would suggest that Ms. Galante has not been performing well. Maybe my eyesight is not good, but I look at that second chart, and it seems to me in the time period that she has become the acting head, in fact, the performance of the portfolio under her watch has gone from the negative performance that existed before her watch to a positive performance, significantly positive performance during her watch. Is that a fair statement?

Mr. DONOVAN. That is absolutely fair. I would add that the chart just to the left of it also shows that we have done that while reducing FHA's market share. So we have taken steps to try to bring private capital back to shrink our market share, but still to have the performance improve substantially.

Senator MENENDEZ. Do you have a different view than Moody's data that shows that the FHA's presence in the market prevented housing prices from dropping another 25 percent?

Mr. DONOVAN. I think that is as good an analysis, as thorough an analysis as we have seen of the important impact that FHA had on the market and, frankly, what would have happened if we had not been there as you see—Congress intended FHA to be here when the country went through a crisis, either a regional crisis where there was not lending available or a national crisis. And that is exactly the role that FHA played with that increase in market share. We agree it is time, as the market is improving, to shrink that share, but not to do it in so precipitous a way to raise premiums or to take other steps that would hurt what is still a fragile recovery.

Senator MENENDEZ. And I would simply say that in a time in which the housing market, although we see some indicators moving upward and prices, values moving upward, it is still a very significant challenge. And just like a doctor, I mean, I think the principle starts off with you do no harm, especially when you are in the midst of a challenging recovery.

So I look forward to seeing how we move in this dual track of making sure the taxpayers are held whole, but at the same time preserving some of the core missions of FHA.

I want to turn to hurricane recovery. This hurricane, Mr. Chairman, we are not used to hurricanes in the Northeast. We have been blessed not to have them. But when you have a superstorm that comes with a full moon, high tides, and a drawing-in of what was the hurricane because of a front that came from the west, you have a perfect storm in all of its iterations.

I have lived in the State of New Jersey my whole life. I have never seen the type of devastation that exists in the State. The pictures that some of my colleagues have seen on television and whatnot do not do justice to the death and scope of devastation. We have thousands of people who do not have a home to go back to. I know that when people talk about the New Jersey shore because of some of these shows, they think of a certain thing. These are people's homes. I am not talking about second homes. I am talking

about their lifetime homes, year-round communities that do not have a home to go back to. I am talking about a $35 billion tourism industry that is largely devastated. I am talking about the megaport of the east cost, the port of New York and New Jersey that suffered huge damages, 250,000 jobs, $30 billion of economic activity for the Nation, national security because we closed the only port in the Northeast in Bayonne, New Jersey, that was a military port, and now we use the commercial port for forward deployment when we need to in the case of emergencies. And I could go on and on.

So, Mr. Secretary, in your other role here, I want to get a sense from you as to the commitment of this administration and the Federal Government to helping New Jersey, and certainly New York as well and the region, recover. Because, you know, when we had Hurricane Katrina on the gulf coast in Mississippi and Alabama and Louisiana, I was there; when we had tornadoes in Joplin, Missouri, I was there; when we had flooding along the Mississippi, I was there; when we had crop destructions in the Midwest, I have been there—because I believe this is the "United" States of America. And so I fully expect that now that for the first time we have the type of devastation that others have suffered and should understand, that we are going to have the type of response that others have received.

And so I would like to get a sense of—I know we are working toward this goal, but I would like to get a sense from you as to the type of commitment that this administration has toward those goals.

Mr. DONOVAN. Senator, thank you for the eloquent remarks about this. As you know, this is a region I, too, have deep roots in. I think, to use your term, I "married up," married a Jersey girl, and have worked in New Jersey, grew up in New York. And besides the personal commitment I feel, I have also seen a President who was on the ground in New Jersey almost immediately, has done everything he can to help the short term, and has given me the responsibility to help make sure that this recovery is a full, complete recovery, not just to build back what was there but to build back smarter and stronger.

So you have my commitment that we will do that. We will propose a supplemental this week that I hope you will see demonstrates that commitment. But we will also be committed to making sure that we get that supplemental passed in the next few weeks because, frankly, there are too many homeowners, too many small businesses, too many renters that have lives that are simply on hold until they know what resources will be available to them to rebuild.

FEMA cannot by statute provide for a full recovery. They are a response organization. And we need to take further steps through a supplemental this month to be able to move toward a fuller recovery and give those families and those businesses some hope that there is a future for them in New Jersey and around the region.

Senator MENENDEZ. Well, Mr. Chairman, let me close, if I may, with your indulgence, because of the nature of this issue, by saying, number one, we await what the supplemental looks like, and we will reserve judgment until them.

Number two, regardless of the size of the supplemental, we need flexibility in being able to seek the recovery that we all want.

Number three, in addition to a perfect storm, there is another perfect storm here. We get this storm in the midst of the beginning of winter. Most of the hurricanes are in gulf seasons, in summer seasons, totally different in terms of the consequence to people—huge in terms of the impact, but still time to recover without the ravishing of the winter months.

If we have a northeaster, our defenses are so far down that it would be like a person's immune system being susceptible to any type of illness. And, third, we come with less than 30 days to the end of a Congress in which this has to be done. I feel like I have to be Houdini to accomplish this, so—but we are going to do this. We are going to do this. And so, Mr. Secretary, I look forward to your work and your help as we get there, and to our colleagues as well.

Thank you, Mr. Chairman, for your indulgence.

Chairman JOHNSON. I would note that Senator Menendez will chair our Subcommittee field hearing in New Jersey next Monday, December 10, on Superstorm Sandy.

Senator Toomey.

Senator TOOMEY. Thank you, Mr. Chairman, and thank you, Mr. Secretary, for joining us.

I would like to understand better an aspect of the actuarial review, and the question that I have arises from the interest rate assumptions and the interest rate environment that is used to determine the prevailing view about the value of the Mutual Mortgage Insurance Fund, the single-family fund.

More specifically, you observe on page 8 of your testimony the fact that the lower the interest rate environment, the worse shape the fund is, to simplify things. You walk through the mechanisms by which lower interest rates, while good for the economy overall, tend to have an adverse impact on the value of the fund.

My understanding is that the actuarial review contemplates a low interest rate environment, and in the low interest rate environment, the value of the fund is negative $31 billion.

Aren't we in a low interest rate environment today? And aren't we by virtue of what the Fed has said, which is to say, maintaining current policy at least through mid-2015—so 3 years or so, at least—isn't it very likely that we are going to stay in a low interest rate environment? And shouldn't that be the prevailing environment assumption?

Mr. DONOVAN. You make a very important point in terms of the fact that the actuarial review was done not today but at a point with economic projections that are primarily in July, over the summer.

Senator TOOMEY. Right.

Mr. DONOVAN. And so it is accurate that interest rates have dropped further than were built into the primary actuarial view. There are two offsetting factors to that, though.

One is that home prices have performed better than were used in the actuarial, and based on what we know today, even for this year, the actuarial would be significantly better if it were performed today just on that one variable.

And then the second point is that the actuarial review is a point in time that assumes that we do no further FHA business, and one of the things that is artificial about it, if I can use that term, is that when interest rates go lower, it assumes people pay off faster. That is accurate. What it does not take into account is that typically about half of those folks refinance into an FHA loan. So by the nature of the actuarial, taking a snapshot in time, assuming that you are closing down the fund, there are revenues that will come to the fund that are not built in.

Senator TOOMEY. Right.

Mr. DONOVAN. All that being said, we will in the President's budget include the lower interest rates that you describe; we will also include an updated projection of house prices; and at that point, we will have a clearer picture of how these offsetting factors play. But it would not be accurate to say that the right number is today the $30 or $31 billion because of that.

Senator TOOMEY. Do you believe that the difference in home prices that prevail today versus at the time that this was done and the difference in the volume that you referred to would be enough to offset the lower value that is caused by the fact that we are in a lower interest rate environment?

Mr. DONOVAN. The truth is, just to be honest, we have not finished those calculations. We are in the midst of doing that for the budget. What I will tell you is they are both large effects, and it is certainly conceivable that they could be offsetting or in the range of offsetting, but we simply do not have an answer to that.

Senator TOOMEY. It is a pretty large effect that comes from the difference in the interest rate. Do you know what the low interest rate environment scenario assumes for the 10-year Treasury yield, by any chance?

Mr. DONOVAN. Let me ask my crack team behind me to get that. We will have that for you in a moment.

Senator TOOMEY. All right. My guess is—I am not sure even that assumption is as low as the rate is today. With an interest rate, 10-year Treasury, of about 1.6 percent, it is shockingly low, and we have a Fed insisting that it is going to keep it this way for a long time. So I will be very interested in seeing what the net effect of these changes are because we know that the interest rate component will reflect a significant adverse valuation here.

Mr. DONOVAN. Yes. But, again, I would just point out that there is an artificiality of the point in time because it presumes every one of the payoffs, we have no more revenue to FHA; whereas, in fact, we know a large number of those refinance——

Senator TOOMEY. So you are saying there is a flaw in the model.

Mr. DONOVAN. No, no. Congress requires that the actuarial review be done in a way that is what we call a "runoff scenario."

Senator TOOMEY. OK.

Mr. DONOVAN. We also in the actuarial look at what if we keep doing business, so we have those projections in the actuarial. That is not the 2-percent calculation, but it is something that we could sort of give you more detail on from the actuarial of what the net effect would be with the refinances.

Senator TOOMEY. The other question is: Does the modeling assume any recession between now and 2017?

Mr. DONOVAN. The modeling does include a range of runs from a mild recession to a very severe recession, and through the kind of stochastic nature of the modeling, we do look at probabilities for those recessions——

Senator TOOMEY. But the model that comes up with a valuation of negative $13.5 billion, does that assume a recession?

Mr. DONOVAN. It assigns probabilities to the potential for different types of recessions and builds those in. I am not sure if I am being clear, but it is not——

Senator TOOMEY. All right. Let me put it this way: What is the average economic growth rate that is implicit in or explicit in that valuation?

Mr. DONOVAN. Again, I can get that for you momentarily.

Senator TOOMEY. OK.

And my last point, the Senator from New Jersey made a very important and impassioned argument about the effects of Hurricane Sandy. In Pennsylvania, we had very significant damage, but it was exclusively from wind, almost entirely from wind damage. Millions lost power. But the damage was not comparable to the damage that was compounded by the water damage, of course, that was done along the shore. I am looking forward to seeing a supplemental that is well crafted and, I hope, properly offset, because we also have a fiscal crisis of enormous magnitude. So the necessary spending to address emergencies is very real, but it is really important that that be offset.

Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to thank Secretary Donovan for his testimony and for being here with us today.

The financial stability of the FHA is an issue that the Committee does not take lightly, and we will continue this dialog and take action where necessary to protect taxpayers.

We appreciate your testimony, Mr. Secretary. This hearing is adjourned.

Mr. DONOVAN. Thank you, Mr. Chairman.

[Whereupon, at 11:36 a.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SHAUN DONOVAN

SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

DECEMBER 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today regarding the status of the Federal Housing Administration's mortgage insurance programs. The testimony will cover the single family programs, for which we recently submitted a report on the Mutual Mortgage Insurance Fund (MMIF), as well as the multifamily and health care programs.

I appear before you today at an important point in the recovery of the Nation's housing markets. As 2012 draws to a close, a number of promising signs indicate that our economy is improving and that the recovery of the housing market is underway. The number of families falling into foreclosure is half what it was in the early days of 2009. Housing construction is growing faster than at any time since 2008, and this has been the strongest year of home sales since the crisis began. Finally, rising home values have lifted 1.3 million families above water in the first half of 2012. All of these indicators point to a housing sector on the mend—a sector vital to the broader recovery of our economy.

However, while there is cause for optimism, we must remain mindful that the recovery remains fragile, and that a broad array of factors could limit the progress we are now seeing. Therefore, we must remain diligent in our efforts to restore our housing markets, help families get back on their feet, and enter into a new era of housing finance in this country.

I. Overview of Findings of the Independent Actuary With Regard to FHA's Single Family Programs

It is with this context in mind that I now want to turn to a discussion of FHA's single family programs. Much of the progress that we are seeing in the housing sector has been possible because of the FHA, which has provided access to home ownership for millions of American families and without which the crisis would have been much deeper. In fact, Moody's analytics estimates that were it not for FHA's presence during the crisis, house prices would have fallen 25 percent further than they did already.

FHA's contribution has not been without stress, however. On November 16, 2012, HUD delivered its fiscal year (FY) 2012 Report to Congress on the Financial Status of the FHA Mutual Mortgage Insurance Fund, which is used for FHA's single family programs. That report summarizes the results of the independent actuarial review conducted by Integrated Financial Engineering (IFE) and provides a status report on the fiscal health of the MMI Fund. Via its review, the actuary measures the economic net worth of FHA's portfolio—essentially, the total value of the portfolio after FHA pays all expected claims for the next 30 years in a run off scenario where no new loans are insured. This economic value is then divided by the total value of the MMI Fund's insurance in force to derive an estimated capital reserve ratio for the Fund. According to the latest findings of the independent actuary, in fiscal year 2012 the capital reserve ratio of the Fund fell below zero to negative 1.44 percent, and the Fund's economic value stands at negative $16.3 billion. Earlier books of business continue to be the prime source of stress to the Fund, with fully $70 billion in claims attributable to the 2007–2009 books of business alone. In contrast, the actuary attests once again to the high quality and profitability of books insured since 2010. Thus, this year's report shows that even though our books of business insured since 2010 are the strongest in agency history, there is still work to be done in mitigating the impacts to the Fund of losses stemming from older books of business which were most severely impacted by the recession and other risk factors, such as seller-funded downpayment policies. Toward this end, a series of aggressive measures FHA will take in this fiscal year is discussed later in this testimony.

While the actuary's finding regarding the economic net worth of FHA's portfolio is obviously of very serious concern, it is not the determining factor for whether FHA will need to draw on permanent and indefinite budget authority from the Treasury. Any determination that such a draw is necessary will not be made until the end of FY2013, and in any event, does not affect the full faith and credit of the Federal Government to pay any claims. In the intervening period, the President's budget will outline the Administration's expectation of whether or not FHA will need assistance by the end of the fiscal year. However, the ultimate need will be borne out in the actual performance of the FHA single family program over the course of the fiscal year, and will be impacted by the steps FHA takes over the course of the year to increase revenue or reduce losses.

While the magnitude of the figures involved in this year's budget reestimate are large, as an example, the President's FY2013 budget submission, issued in February of this year, anticipated that FHA would need to draw nearly $700 million in assistance from the U.S. Treasury in order to satisfy the required transfer of funds from the Capital Reserve Account to the Financing Account to meet expected claim obligations. Instead, at the end of FY2012 the Capital Reserve Account held $3.3 billion—even after the transfer for these expected costs. The fact that the MMI Fund ended the year with this balance is due primarily to policy changes made during the fiscal year that substantially improved the value of the Fund. Likewise, the series of additional changes FHA has announced and which are described below are designed to reduce the likelihood that FHA will need to draw on Treasury assistance at the end of FY2013.

We will continue, as we have throughout this Administration, to be diligent in taking every action appropriate to protect taxpayers while continuing to ensure that FHA supports the stabilization of the housing market, and that families have access to sustainable mortgage credit options.

II. The Role of FHA's Programs in the Nation's Housing Finance System

As we discuss the current status of FHA's programs and finances, it is important to frame this discussion within the context of the role FHA has played historically in the Nation's housing finance system. Throughout its history, FHA has supported access to affordable, sustainable mortgage financing to persons and entities underserved by the conventional market. Through its single family, multifamily and health care loan guarantee programs, FHA has acted as a stabilizing force in the housing market during times of economic distress. At no time has this countercyclical influence been more pronounced than during the recent housing crisis. In the face of ongoing challenges in these sectors, FHA has continued to provide access to mortgage finance opportunities during a period of severe constriction in conventional markets. As a result, FHA has played a central role in bringing the housing market from the brink of collapse to a place where the outlook is positive and improving.

Since its inception in 1934, FHA has provided access to home ownership through its single family programs for credit-worthy lower wealth or otherwise underserved borrowers, enabling more than 40 million families who might otherwise have been prevented from doing so to realize the American dream of home ownership. In addition to providing access to financing for credit-worthy borrowers by insuring mortgage lenders against losses on defaulted loans, FHA's single family programs have also offered crucial liquidity in the mortgage finance system during periods of market stress. Whether providing ongoing credit availability in areas experiencing regional recessions, or ensuring nationwide liquidity during broader economic crises such as we have recently experienced, FHA has repeatedly acted as a vital stabilizing force in the single family mortgage market when constriction in conventional lending threatens effective functioning of the market.

Likewise, FHA's multifamily and health care programs have been very important to facilitating credit availability in their respective sectors. These programs provide critical mortgage financing opportunities that strengthen communities by addressing specialized financing needs including insurance for loans to develop, rehabilitate, and refinance multifamily rental housing, nursing home facilities, and hospitals. These sectors faced a severe contraction in the availability of conventional financing, as well as a near collapse of the tax exempt bond market, making FHA's programs essential. FHA multifamily and health care mortgage insurance programs operate under FHA's General Insurance-Special Risk Insurance (GI–SRI) Fund, which is separate and distinct from the MMI Fund used for single family programs.

III. FHA Single Family Programs

Created in the aftermath of the Great Depression and designed to expand access to home ownership that would in turn stimulate the ailing residential housing markets, FHA played a central role in developing today's mortgage finance system. It redefined mortgage underwriting practices so that qualified borrowers could obtain mortgage financing, and it standardized construction and appraisal requirements so that mortgage contracts could be tradable across the country. Even more important than FHA's contribution to developing modern mortgage standards and practices, however, has been its role as a countercyclical force that ensured continued liquidity throughout the mortgage finance system during periods of economic stress. This has been true on a number of occasions at the regional level as FHA has offered support for mortgage financing in specific geographies experiencing localized recessions, and much more so as FHA has played a prominent role in stabilizing the market and averting a total collapse of the housing market during the recent crisis. By design,

FHA's programs are meant to complement, not supplant, private capital. It is there to combat a lack of available mortgage credit when private capital retreats or underserves markets, and to step back when private capital returns or expands to serve previously underserved populations. And because of this unique role, its business cannot and should not be evaluated on the same terms as a private firm, as such a requirement would force FHA to act as a private firm and therefore eliminate its value in providing countercyclical liquidity and credit to underserved markets.

A. FHA Single Family Activity in FY2012

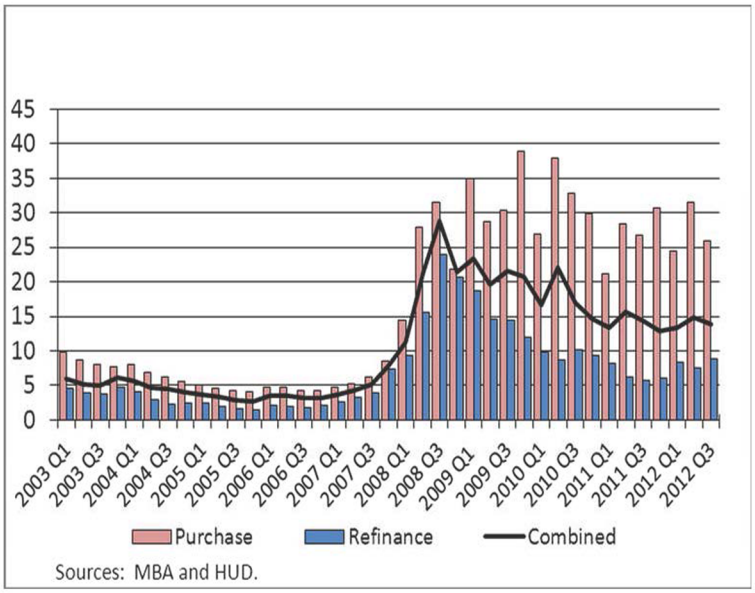
In 2012, FHA continued to play an important part in the ongoing recovery of the Nation's housing market and broader economy. FHA insured nearly 1.2 million single-family forward mortgage loans during the year, with a total dollar value of approximately $213 billion. Of the over 700,000 homepurchase mortgages endorsed during the year, 78 percent were for first-time homebuyers, reaffirming FHA's role in providing access to new entrants to the home ownership market. Indeed, over the past four fiscal years, FHA has insured mortgages for over 2.8 million first-time buyers.

FHA has also continued to be a vital source of home financing for minority borrowers. While FHA insurance was used for approximately 27 percent of all home purchase mortgages in 2011, FHA accounted for 50 percent of home purchase mortgages for African American borrowers and 49 percent for Latino borrowers.

Clearly, FHA has played a very crucial role in facilitating continued liquidity in the single family mortgage finance market, preventing even more severe economic circumstances during the recession. As Moody's Analytics Chief Economist Mark Zandi said in a *Washington Post* article, "If FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it." Moody's estimates that were it not for FHA's presence during the recent crisis, house prices would have fallen an additional 25 percent, resulting in 3 million more job losses and a reduction of economic output of $500 billion.

Although FHA continues to be an important source of access to credit for American families, its market share continues to decrease as the economy recovers and private capital begins to return to the market. New insurance endorsement activity in FY2012 fell once again from that of the prior year, continuing its decline from the peak levels seen in FY2009. In terms of dollars of single-family loans insured, 2012 is the lowest volume since the start of the crisis. Home Equity Conversion Mortgage (HECM) insurance endorsements in FY2012 were also down by 25 percent from FY2011 levels, to 54,591 loans. FY2012 marks the third consecutive year in which HECM volume declined, as the combined effects of policy revisions to the product and changes within the industry have reduced participation in the program.

FHA Market Share as a Percent of Mortgage Originations by Type



FHA has served an important and necessary role in the Nation's housing finance system throughout the past year. Because of the agency's importance to the overall health of the housing market and its responsibility to American taxpayers, FHA constantly seeks to balance efforts to provide access to credit for underserved borrowers and ensure continued liquidity in the system with its responsibility to prudently protect the health of the MMI Fund. Throughout the current Administration, we have continually sought such balance in establishing policies and practices for FHA.

B. The Mutual Mortgage Insurance Fund

The important services FHA single family programs provide to the Nation's housing sector are made possible through FHA's Mutual Mortgage Insurance Fund. The MMI Fund operates with two primary sets of financial accounts:[1] a Financing Account, which reflects the business transactions related to insurance operations, and a Capital Reserve Account, which reflects secondary reserves for unexpected claim expenses. Both of these accounts are held at the U.S. Treasury. The Capital Reserve Account is unique to MMI Fund operations. It was established to assist in managing to the 2-percent capital ratio requirement enacted by Congress in 1990. FHA's MMI Fund programs, however, are backed by the full faith and credit of the U.S. Government, and like all Federal Government direct-loan and loan-guarantee programs, its financing account operates with what is called "permanent and indefinite budget authority." This authority provides access to the U.S. Treasury for any funds needed to pay claim obligations, and provides assurance to lenders and investors that FHA programs are never in jeopardy of lacking sufficient funds to pay insurance claims. That would be true even in the absence of a Capital Reserve Account.

The Fund is subject to two distinct portfolio valuations each year. Both project all future revenues and expenses based upon a forecast of loan performance under defined economic conditions. One is performed by an independent actuary in accordance with requirements of the National Housing Act, and the other is the annual

[1] 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.

subsidy reestimate performed by the Administration under the terms of the Federal Credit Reform Act and published in the President's Budget.

The independent actuarial study uses statistical models to develop 30-year projections of 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.

This year, the actuarial study applied a stochastic method to estimate the net present value (NPV) of future cash flows. The move to a stochastic method represents one of the advancements that have been made to the actuarial modeling process this year and is implementing recommendations by the GAO and the HUD OIG. In previous studies, the net present value of cash flows was computed along a single path of house prices and interest rates. This year, 100 equally likely paths were generated to develop a wide variety of possible economic conditions, creating what is known in mathematical terms as a Monte Carlo simulation. The discounted, net present value (NPV) of cash flows was computed for each path. They were then averaged to obtain an overall estimate of the expected NPV that provides the base-case estimate.

The outcome of the complete actuarial study modeling effort is the estimated "economic net worth" of the MMI Fund, which is defined by the National Housing Act as capital resources plus the present value of future cash flows of the MMI Fund. The calculation of economic net worth is repeated for each of the next 7 years by adding projected endorsements each year, forecasting their cash flows and adding them to those of the current portfolio, and then reassessing economic net worth on the updated portfolio at the end of each fiscal year.

Economic net worth represents additional resources directly available to FHA for absorbing claim expenses above-and-beyond those already anticipated in the present-value-of-future-cash-flow calculations. Those calculations are for the remaining life of all outstanding loan guarantees and can extend for more than 30 years on HECM loans. Economic net worth is the numerator of the statutory capital ratio measure. The denominator is the outstanding dollar volume of active insurance contracts.

The credit subsidy reestimate is performed each year as part of the Federal budget process in accordance with the budget valuation of all Federal direct loan and guarantee programs. For FHA single-family programs, this evaluation uses a modified version of the actuarial study forecasting model, applying the economic assumptions common to the President's Budget. The estimate is used to determine any necessary transfers between the MMI Fund Financing and Capital Reserve accounts, based on projections of expected claims and premium revenue on outstanding loan cohorts over their remaining lifetimes (up to 30 years). It is this estimate that establishes any expected need to draw on support from the Treasury to ensure possession of sufficient capital resources to meet all future expected claim costs. Permanent and indefinite authority from Treasury is only necessary if FHA is unable to satisfy the budget reestimate requirements from the funds in the Capital Reserve at the end of the fiscal year.

C. The FY2012 Actuarial Review

This fiscal year, as noted above, the MMI Fund capital reserve ratio fell below zero to negative 1.44 percent. The actuarial assessments estimate that the economic value of the Fund as of the end of FY2012 is negative $16.3 billion against an active portfolio of $1.13 trillion. The economic value of the forward portfolio was estimated at negative $13.5 billion, the HECM portfolio at negative $2.8 billion. These economic values represent capital reserve ratios of negative 1.28 percent and negative 3.58 percent respectively. The actuary projects that the MMI Fund capital reserve ratio will be positive by FY2014 and reach 2.0 percent during FY2017 under its base-case estimate. These forecasts assume no changes in policy or other actions by FHA, including those that were announced when the actuarial report was released last month that might accelerate the time to recovery.

The low capital ratio today reflects an expectation that FHA's current pool of insured loans still has significant foreclosure and claim activity yet to occur. Projected losses are particularly large for the fiscal year 2007–2009 loans. Those loan cohorts were impacted by the severe recession and accompanying increases in unemployment, and by large volumes of seller-funded downpayment loans. Indeed, loans insured from 2007–2009 are projected to yield more than $70 billion in claims for FHA.

Loans using seller-funded downpayment assistance have proven to place substantial stress on the Fund. Those loans are projected to cost the Fund $15 billion as they continue to experience elevated rates of insurance claim. In fact, the Actuary estimates that, if FHA had not insured any seller-funded-downpayment loans, the net economic value of the MMI Fund would be positive $1.77 billion today. Thus, we are very grateful for the action by Congress in 2008 to eliminate seller-funded downpayment loans from the FHA program, avoiding substantial additional losses from these loans.

In contrast to the drain caused by those older loans, the actuary expects endorsements in fiscal years 2010 through 2012 to produce significant net revenues that can be used to partially offset losses from earlier books of business. The contrast in quality between these two vintage eras—pre- and post-2009—is demonstrated by the following table.

Lifetime Economic Value by Endorsement Vintage (Forward Loans)

Vintage	Original Loan Balances ($billion)	Present Value of Premium Revenue	Present Value of Credit Losses	Economic Value (%)	Economic Value ($billion)
1992 - 2006	$1,190	3.5%	5.1%	(1.6%)	($19.5)[1]
2007 - 2009	564	3.8%	11.0%	(7.2%)	(40.6)
2010 - 2012	721	6.0%	2.9%	3.1%	22.7
Total	$2,475	4.3%	5.8%	(1.5%)	($37.4)

[1]1992-1999 cohorts were profitable, while 2000-2006 cohorts were not. The combined values of all cohorts yields the negative values shown here.

Source: FY 2012 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

While the general trends revealed in this year's actuarial report are consistent with those reported in the reports of the past few years—books of business insured through 2009 are placing a great amount of stress on the MMI Fund while those insured since 2010 are adding substantial value to the Fund—the overall results in this year's actuarial report differ substantially from last year's projections on the status of the Fund at the end of this fiscal year. There are three factors driving the change in the estimated economic value of the MMI Fund compared to what was projected last year:

First, the Moody's July 2012 house price appreciation forecast, which was used in this year's actuarial study, predicted significantly lower levels of appreciation in the near term than the forecast used in last year's actuarial study. This results in a cumulative difference in projected house price appreciation of 8 percentage points over the first 5 years. Thus, this downward revision in house price forecasts from last year to this year accounted for an estimated $10.5 billion in reduced economic value compared to the actuary's 2011 projection of what the Fund's economic value would be as of the end of FY2012. Further, near-term house-price movements in the index used by the actuaries were depressed by high levels of refinance activity in 2012, and therefore, they do not reflect improvements seen this year to home prices in other measures of housing market strength. Additionally, because the forecast utilized only covers the period through June 2012, it does not include substantial improvements to home prices seen since that time. Second, the continued decline in interest rates since last year, while good for the overall economy, causes a sub-

stantial loss of revenue. The reasons for this are two-fold. First, because of the higher interest rates being paid by borrowers on loans made before 2009, the actuary projects that these borrowers will default at marginally higher rates than would otherwise be expected. Second, the actuary projects that FHA loans would be paid off earlier than expected through refinances that take advantage of the lower rates, and because the methodology required by statute that the actuary utilizes assumes that none of these loans will refinance back into FHA. The effect of these two assumptions by the actuaries resulting from a prolonged period of low interest rates is a reduction of $8 billion in estimated economic value for the Fund from what was anticipated in last year's report.

Third, based on recommendations made by the GAO, HUD's Inspector General, at FHA's direction, the actuary employed a refined methodology this year to adjust the way losses from defaulted loans and reverse mortgages are reflected in the economic value of the MMI Fund, resulting in an estimated $13 billion in reduced economic value compared to last year's projections. Specifically, shares of Pre-foreclosure sale (PFS or short sales) and REO in claim predictions are now explicitly modeled, and each has its own loss rate forecast. PFS share of claims is now less than half of what was implied in past models. Also, model structure changes removed an artificial cap on the effect of declining home prices on REO loss rates.

It should be noted that while the shift in value from what was projected last year to what was calculated in this year's review is substantial, last year's actuarial report did indicate that should house price appreciation or interest rates deviate from the base case scenario used for the actuary's projections, such deviations would impact the Fund's value in FY2012. Furthermore, last year's report stated explicitly that there was an approximately 50 percent chance that if economic forecasts differed from those used in the FY2011 report the Fund would have a negative value. These findings were the result of stress testing requested by HUD. While stress tests are not required by statute, FHA directs the actuary to perform them annually to provide greater insight into what may be expected if conditions deviate from those envisioned in the base case scenario. This year, FHA asked the Actuary to estimate the value of the Fund based upon those economic paths that yield the 10th best, 25th best, 25th worst, 10th worst, and the singular worst projected economic values. Additionally, the Actuary was also asked to evaluate two additional scenarios which represent singular, deterministic economic paths with no random fluctuations. First was the Moody's Protracted Slump Scenario, the most stressful alternative scenario forecasted by Moody's Analytics in July 2012. Second was a Low Interest Rate Scenario, representing a continuation of the historically low interest rate environment prevailing at the end of FY2012.

The significant shift in dollar value this year from what was expected in last year's report highlights the volatility associated with 30 year projections of economic conditions. Additionally, they are indicative of what occurs when underlying factors change for a portfolio the size of FHA's. The $23 billion difference between the estimated value of the Fund in this year's actuarial review versus that projected in last year's represents only a 2 percent shift in value.

D. Actions Taken to Date To Protect the Fund

Throughout the tenure of this Administration, FHA has taken aggressive and decisive actions to improve the health and trajectory of the MMI Fund, while ensuring continued access to mortgage credit for American families. The changes made to FHA policy since 2009 are projected to have improved the economic value of the Fund by at least $20 billion. That FHA's capital ratio has remained positive until this year is primarily due to the reforms to risk management, credit policy, lender enforcement, and consumer protections made over the past 4 years—the most sweeping changes to policy in FHA's nearly 80 year history. Our efforts to date to strengthen FHA have been focused on eliminating unnecessary risks and ensuring sufficient revenue generation from new endorsements while continuing to learn from what is working in our efforts to improve FHA's asset management and loss mitigation approaches.

1. Counterparty Risk Management and Lender Enforcement

Toward these ends, one of the first things this Administration did upon taking office was to take strong actions to improve FHA's monitoring and oversight of lenders. This has included substantial improvements to risk analysis systems and procedures, and policy changes to focus resources on the areas of FHA's business which pose the greatest potential risk to the MMI Fund. These efforts have resulted in record numbers of lenders being withdrawn from FHA programs, substantial improvements in lender compliance with FHA requirements, and a number of settle-

ments with lenders and servicers for violations of FHA origination or servicing requirements.

2. Credit Policy

We have also worked to strengthen our credit policies for FHA borrowers. First and foremost, FHA implemented Congress's elimination of seller-funded downpayment assistance programs which cost the MMI Fund more than $15 billion in economic value. Further, we enacted increased downpayment requirements for borrowers with credit scores below 580. The long-term positive impact of these two credit policy changes cannot be overstated. The 2005—2008 vintages, accounting for less than 15 percent of total originations over the last 30 years, are projected by the Actuary to contribute more than one-third of total credit losses of the Fund. Loans with credit scores below 580 and/or seller-funded downpayment assistance will have accounted for 44 percent of those losses. Additionally, we have worked to reduce the amount of allowable seller concessions that increase risks to FHA arising from inflated appraisals. Together, these measures will better ensure that home buyers using FHA-insured financing are capable of meeting their mortgage obligations and won't put undue stress on the Fund.

3. Increased Revenue

In addition to the improvements made to the quality of new endorsements, we have also made the difficult choice to increase mortgage insurance premiums for FHA-insured loans multiple times in the past 4 years. Since 2009, FHA has increased premiums four times—the most recent increase coming in response to the FY2011 actuarial review. Combined, the premium increases made since 2009 have yielded more than $10 billion in additional economic value for the Fund. These increases have not been undertaken lightly, and FHA has been careful to balance changes to pricing to improve the outlook of the Fund with its countercyclical role of providing liquidity and access to credit in the midst of the recent crisis and ongoing recovery.

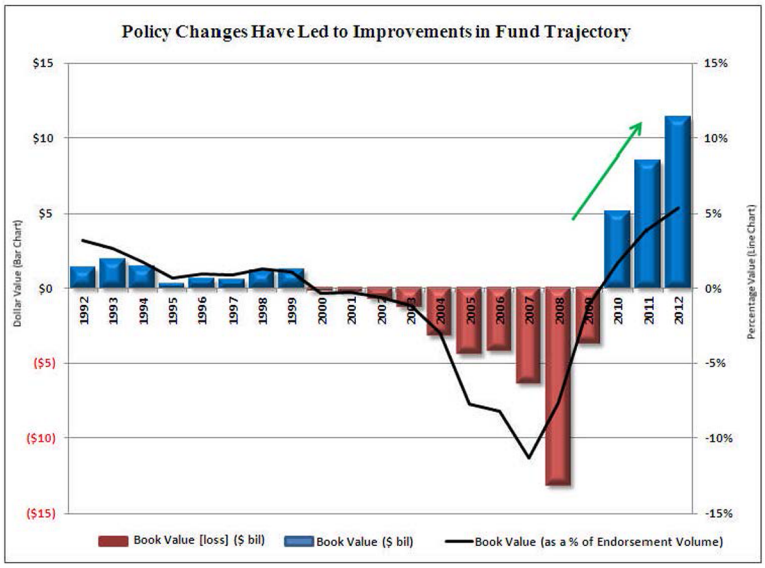
4. Loss Mitigation and Asset Management

FHA has not just addressed issues associated with the origination of new loans, but has also taken decisive steps to control costs and limit losses on the back end of its business through improvements to its REO disposition processes and loss mitigation strategies. First, we changed our strategy and approach with regard to the REO management and marketing contracts through which FHA's REO property inventory is managed and sold. Enhancements to the oversight of contractors and better monitoring of their compliance with FHA guidelines, as well as measures which promote competition and continuity within specific markets, have resulted in notable improvements to FHA's REO processes. As a result of the changes HUD has made, the gap between appraised values of REO properties and their sales prices has decreased by 62 percent and the time in inventory for FHA properties has reduced by 45 percent, decreasing losses on the REO portfolio and improving recoveries for the Fund.

Finally, in FY2012, FHA implemented a significant expansion of its note sales program whereby nonperforming loans are sold in pools at a market-determined price via auction to investors, who are then able to explore options for homeowners to either remain in their homes or obtain a viable nonretention solution. This initiative, known as the Distressed Asset Stabilization Program (DASP), exponentially expands the number of loans sold in each sale while introducing innovations designed to promote stability in hard hit geographies. In addition to the sale of pools comprised of properties located throughout the Nation, FHA also created Neighborhood Stabilization Pools of loans concentrated in specific Metropolitan Statistical Areas (MSAs). For the first sale in this expanded program, the MSAs of Newark, Tampa, Chicago, and Phoenix were selected for inclusion in the program. These pools included additional requirements targeted at reducing the inventory of vacant foreclosed properties in these communities and providing enhanced options for homeowners and community members to benefit from these properties that would otherwise end up in FHA's REO inventory. The initial results from the first DASP sale were positive, resulting in the Actuary's estimate of improved economic value for the Fund from this initiative of more than $1 billion over the next 2 years.

The effectiveness of these changes can be seen in the stark contrast between books of business insured prior to 2010 and those insured since that time, which is clear in the graph below.

Economic Net Worth by Book-of-Business



Source: FY 2012 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

E. Actions To Be Taken in FY2013

While FHA has enacted substantial reforms under the current Administration, this year's actuarial review makes clear that loans made prior to and at the outset of the recent crisis continue to weigh heavily on the health of the MMI Fund. Therefore, building upon the significant efforts already undertaken to protect and preserve the MMI Fund, FHA is implementing a series of additional actions to continue improving the Fund's trajectory over both the short and long term. Using the Actuary's model, collectively, these changes are projected to provide billions of economic value for the MMI Fund in FY2013.

1. Reduce Losses From Legacy Books of Business

The changes made since 2009 to FHA's lender oversight, credit policies, and premium pricing have yielded substantial improvements in the quality of new loans endorsed by FHA. But significant opportunity remains to reduce the impact on the Fund of poorly performing legacy loans severely impacted by the recession, and to provide greater assistance for distressed borrowers as they seek to recover and find meaningful assistance in dealing with their delinquent loans. With a majority of FHA's projected losses attributable to loans insured from 2007–2009, FHA will take several additional steps to maximize recovery in the areas of loss mitigation and asset management.

The Actuary projects nearly $60 billion in claims costs for FHA from seriously delinquent loans that will go to claim by the end of FY2014, largely arising from loans insured between 2007 and 2009. As a result, reducing the severity of losses derived from these loans will exert a demonstrable positive impact to Fund performance over the next few years. Throughout the past fiscal year, FHA has been executing on an overall asset management strategy aimed at ramping up REO alternatives. REO alternatives (primarily short sales) comprised about 15 percent–20 percent of total dispositions since 2010, yielding average loss severities about 20 percent lower than REO. In recent months, as noted, FHA also unveiled its Distressed Asset Stabilization Program (DASP), another REO alternative that improves Fund performance. These and other actions have had a measurable effect, as loss severities have already fallen by 9 percent in the last year A further reduction in loss severities will further improve fund performance.

- Redesign of FHA Modification Treatments to Better Assist Delinquent Homeowners

FHA issued a Mortgagee Letter on November 16, 2012, that established revised standards for repayment plans, standard modifications, and FHA–HAMP loss mitigation products, which are expected better assist distressed borrowers and reduce losses to the Fund from foreclosures. FHA loss mitigation policies will be geared towards greater payment relief for borrowers, targeting payment reductions of at least 20 percent for FHA–HAMP modifications, which will result in more sustainable payment outcomes for borrowers over the long term. This approach will yield lower claim costs for FHA while also reducing prepayment speeds for insured loans, both of which will positively impact the MMI Fund.

- Streamlining of the FHA Short-sale Policy

Although FHA is deeply committed to providing loss mitigation alternatives to borrowers which permit them to retain their homes, home retention is simply not an option for some borrowers. For these borrowers, preforeclosure sales (short-sales) offer an opportunity to transition out of their homes. This enables both FHA and the borrowers to avoid the costs and damages of the foreclosure process. FHA will introduce a streamlined preforeclosure sale policy which removes certain barriers for borrowers in obtaining a short sale on their FHA-insured mortgage. This change is expected to increase the number of defaulted loans that end in short sales rather than foreclosures. Because losses from short-sales are substantially lower than from the traditional FHA REO process, the shift of greater numbers of distressed homeowners to short-sale dispositions rather than foreclosures will yield better results for the MMI Fund while allowing distressed borrowers to start anew without having to go through the difficult and costly foreclosure process.

- Claim Without Conveyance Pilot Program

FHA is conducting a pilot whereby properties secured by nonperforming FHA-insured loans are offered for sale by the lender who has completed the foreclosure process. At a reserve price slightly below the outstanding unpaid principal balance of the loan, the properties are sold to third party purchasers without ever being conveyed to FHA. This method of disposing of these properties may yield lower losses for the MMI Fund than selling them through FHA's normal REO disposition process, as carrying costs associated with preserving, managing, and marketing an REO property were eliminated.

- Proactive Strategies to Further Improve Recoveries

In addition to the policy and programmatic changes outlined above, FHA will also take several innovative and proactive steps to increase utilization of loss mitigation options and reduce unnecessary asset disposition losses. First, beginning in 2013, FHA will launch a large-scale proactive marketing campaign to promote modification and short-sale strategies for delinquent borrowers. This effort is expected to increase utilization of these programs, which will permit more borrowers to become aware of and take advantage of these opportunities, while reducing foreclosures and decreasing associated losses for FHA. In addition, FHA will also pursue more creative strategies to dispose of REO properties in geographies where traditional asset disposition methods yield net negative recoveries for FHA. This approach will both save money for FHA on unnecessary losses as well as contribute to community stabilization initiatives in cities hit hard by the recession.

2. Further Strengthen the Quality and Impact of New Endorsements

While much has been done under the current Administration to improve the performance and revenue of new FHA endorsements, we believe it is vital to take additional steps to strengthen new books to ensure the long term health of the MMI Fund. Accordingly, in the second quarter of FY2013, FHA will implement the following policies for new originations.

- Revised Premium Cancellation Policy

Under a policy change made in 2001, FHA has been canceling required mortgage insurance premiums (MIPs) on loans for which the outstanding principal balance reaches less than 78 percent of the original principal balance. However, FHA remains responsible for insuring 100 percent of the unpaid principal balance of a loan for the entire life of the loan, such loan life often extending far beyond the cessation of MIP payments. As written, the timing of MIP cancellation is directly tied to the contract mortgage rate, not to the actual loan LTV. The current policy was put in place at a time when it was assumed that home price values would not decline, but today we know that LTV measured by appraised value in a declining market can mean that actual LTVs are far lower than amortized mortgage LTV, resulting in

higher losses for FHA on defaulted loans. Analyses conducted by FHA's Office of Risk Management projects lost revenue of approximately $10 billion in the 2010–2012 vintages as a result of the current cancellation policy. The same analyses also suggest that 10 percent–12 percent of all claims losses will occur after MIP cancellation. Therefore, beginning with new loans endorsed after the policy change becomes effective later in FY2013, FHA plans to once again collect premiums based upon the unpaid principal balance of FHA loans for the entire period during which they are insured, permitting FHA to retain significant revenue that is currently being forfeited prematurely.

• MIP Increase

We are very grateful for the flexibility Congress granted us in 2010 to adjust FHA's premium pricing. And we have utilized that flexibility three times already. This fiscal year, we plan to use it once again as, consistent with FHA's continued efforts to balance its countercyclical role in the Nation's mortgage market with its responsibility to manage the Fund, FHA plans to increase annual mortgage insurance premiums by an additional 10 basis points. While the new loans being made today are profitable to FHA and we do not want to over-burden or constrict access to credit as the housing market continues to mend, we also must ensure that we are (1) rebuilding adequate reserves for the future and (2) phasing out of our countercyclical role by reducing FHA's footprint in the marketplace and helping to facilitate the return of private capital. FHA has played a vital part in ensuring access to credit for borrowers and liquidity in the market, yet its current outsized role should and will decrease. Indeed, its market share has declined yearly since a peak in 2009. This premium increase—$13 per month for the average FHA borrower—which FHA plans to implement in 2013 will add significant revenue to the Fund and ensure that FHA does not take on additional market share, while at the same time being modest enough that it doesn't impact borrower access to credit or threaten our emerging housing recovery.

• Future Credit Policy and Pricing Changes

While much has already been done to improve the quality of new FHA endorsements, the effectiveness of which are clear in the performance and projected value of loan cohorts insured since 2010, FHA is continually evaluating its portfolio to identify and mitigate risks, and to provide enhancements that benefit both consumers and the Fund. Based upon these evaluations, FHA is also developing additional proposals which will further assist in strengthening the MMI Fund.

• Housing Counseling Incentive Policy

Significant evidence has shown that housing counseling improves the success of home buyers—particularly first time homebuyers.[2] FHA intends to develop new policies which incentivize, or in some cases require, borrowers to complete a prepurchase housing counseling program prior to the purchase of a home using FHA-insured financing. We will work during this fiscal year to craft and receive feedback on the precise contours of this initiative. This endeavor is expected to ultimately improve outcomes for both borrowers and FHA, reducing losses to the Fund as higher numbers of new borrowers attain successful home purchases.

3. Stabilize and Strengthen the HECM Program

Changes in borrower utilization of the HECM program and the modeling changes employed by the actuary this year show substantial stress in the HECM program. In order to mitigate the negative impact of the 2013 and future HECM books on the MMI Fund, FHA is taking aggressive actions in both the near and long terms to ensure that consumers are better protected and able to sustain their reverse mortgage, while also protecting the Fund.

• Immediate Steps to Reduce Losses in the Near Term

Given current regulatory authority, FHA has limited ability to address root cause issues and will, therefore, be forced to make blunt changes to the program on an interim basis. FHA will take immediate action to better align the program with its objective of enabling seniors to age-in-place. These changes will protect FHA from

[2] HUD conducted a review of prepurchase counseling that was published in 2012, which also found that the program was serving its intended population. The study tracked 573 participants at 12 to 18 months after receiving prepurchase counseling services. Only one of the purchasers had fallen at least 30 days behind on his or her mortgage payments and none had a major derogatory event on a mortgage account. A report on the study's findings can be found at: *http://www.huduser.org/portal/publications/hsgfin/pre_purchase_counseling.html.*

losses and reduce the likelihood of borrower defaults due to nonpayment of property taxes and insurance.

In addition, FHA will consolidate the Fixed Rate Standard program with the Fixed Rate HECM Saver product, resulting in a reduction of the maximum amount of funds available to a HECM borrower. Further, the principal limit factors that are used to determine the maximum amount a homeowner may borrow using the remaining HECM products will be reduced across the board (i.e., Fixed/ARM Saver, ARM Standard).

Additionally, in an effort to reduce losses associated with the conveyance and disposition of properties mortgaged with a HECM, FHA will issue new incentives for estate executors of HECM borrowers to dispose of properties themselves rather than conveying them to HUD. Executors are permitted to either sell such properties or convey them to HUD. Reversing the historical trend, over the past few years, larger numbers of executors have been choosing to convey these properties to FHA rather than sell them, adding costs and reducing recoveries for FHA. By incentivizing the sale of properties by executors, FHA is able to avoid property management, maintenance, and marketing costs associated with the REO disposition process, thereby reducing losses to the Fund on these properties.

- Longer-term Changes to Permanently Strengthen the Program

Over a longer term, either through the granting of the legislative authority described below or via the much longer rule making process, FHA will also pursue other material changes to ensure the long-term viability of the HECM program. These measures include:

- Limiting the draw at origination to mandatory obligations (i.e., closing costs, mortgage liens, and Federal debt), providing greater flexibility in addressing the individual needs of borrowers than the across-the-board reductions to principal limit factors described above, while still protecting the Fund from losses on loans where the maximum loan amount is drawn up-front;
- Performing a financial assessment of borrowers as a basis for loan approval and determining the suitability of various HECM products to protect consumers from acquiring loans not fit for their situation; and
- Establishing a tax and insurance set-aside to ensure sufficient equity or an annuity is available to pay taxes and insurance on the mortgaged property so that defaults resulting from nonpayment of taxes and insurance can be avoided.

F. Legislative Requests to Further Strengthen the Fund

Throughout the past 4 years, Congress has moved in important ways to strengthen and protect FHA, and for that we are very grateful. Indeed, were it not for the flexibility granted by Congress to FHA in 2010 in setting premium pricing, the current economic value of the MMI Fund would be more than $10 billion lower than it is today. And the work this body has done to establish FHA's first ever Office of Risk Management has been instrumental to our improved ability to identify risks in FHA programs and take action to mitigate them. So thank you for your commitment to making FHA stronger and more secure over the long term.

But today, we are asking for your help once again so that FHA is better able to protect the Fund while continuing to execute its mission. The proposals outlined below will enhance FHA's ability to hold lenders accountable for noncompliance with FHA policy and provide greater flexibility for FHA to make changes to policies and procedures as emerging needs and trends are identified. As a result, FHA will better be able to avoid unnecessary losses before they occur.

1. *Indemnification Authority for Direct Endorsement Lenders:* This provision, which FHA has been seeking since 2010, would allow FHA to seek indemnification from Direct Endorsement lenders, which represent 70 percent of all FHA approved lenders. Currently FHA only has authority to require indemnification for lenders with Lender Insurance (LI) approval. In granting this authority, FHA will be able to obtain indemnification from all of its approved lenders for loans that do not comply with its guidelines.
2. *Revised Indemnification Authority:* This change would eliminate the "knew or should have known" standard with regard to fraud or misrepresentation. While the Government-Sponsored Enterprises require lenders to retain all fraud related risk, FHA only holds lenders accountable for fraudulent activity if they "knew or should have known" of its occurrence. Providing proof to meet this standard limits FHA's ability to require lenders to be accountable for fraud in

FHA-insured loans, and its removal would significantly improve FHA's ability to avoid unnecessary losses arising from fraudulent activity.

3. *Authority to Terminate Origination and Underwriting Approval*: This legislation would give FHA enhanced ability to review lender performance and, if a lender is found to have an excessive rate of early defaults or claims, would provide greater flexibility in terminating the approval of the lender to originate or underwrite single family mortgages for FHA insurance. FHA has been seeking this authority since 2010.
4. *Revised Compare Ratio Requirement:* This provision would revise the statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance so that it more effectively captures the true performance of a lender during all market conditions, minimizing further poor performance by FHA lenders while reducing uncertainty for them. Specifically, this legislation would allow the Secretary to compare the rate of early defaults and claims for insured single family mortgage loans originated or underwritten by a lender with those same rates for other lenders on any basis the Secretary determines appropriate, such as geographic area, varying underwriting standards, or populations served. Further, the provision would permit the Secretary to implement such comparisons via regulations, notice, or Mortgagee Letter. This will allow FHA to tailor the compare ratio such that it provides meaningful comparisons of lenders in varying market conditions, providing greater clarity for lenders and a more refined understanding of their performance for FHA.
5. *Authority to Transfer Servicing:* In order to facilitate more effective loss mitigation, this change would give FHA the authority to require any of the following actions when a servicer is at or below a servicer tier ranking score (TRS) of III, or when the Secretary deems the action necessary to protect the interests of the MMI Fund: (1) transfer servicing from the current servicer to a specialty servicer designated by FHA; (2) require a servicer to enter into a subservicing arrangement with an entity identified by FHA; and/or (3) require a servicer to engage a third-party contractor to assist in some aspect of loss mitigation (e.g., borrower outreach). Such authority would permit FHA to better avoid losses arising from poor servicing of FHA-insured loans, yielding better results for both borrowers and FHA.
6. *Authority to Manage the HECM Program by Mortgagee Letter:* This provision would allow FHA to take specific actions via Mortgagee Letter to more effectively manage the HECM program. In light of the HECM portfolio's sensitivity to changing market conditions, this change would provide FHA with the flexibility to make necessary changes as soon as trends or issues are identified within the HECM program.

IV. FHA Multifamily Programs

The use of FHA MF programs increased exponentially during the crisis, providing needed liquidity in the market for MF residential and affordable mixed use buildings despite general constriction in credit markets. FHA has steadily provided liquidity in the market over the past several years in which conventional financing has not been readily available. With historically low interest rates, FHA has seen exponential growth in this area.

Multifamily Units Created During the Crisis:

Basic FHA Initial Endorsements for New Construction of Apartment Units			
FY	# Projects	# Units	Volume ($ millions)
2012	175	27,546	2,714.2
2011	189	30,483	3,080.6
2010	205	37,391	3,767.1
2009	90	15,195	1,363.8
Totals	659	110,615	$10,925.7

Today, as the market recovers, we are beginning to see private capital return to the market and expect to see a reduction in our share of new market rate units. FHA will continue to play a vital role in the creation and preservation of affordable housing and will continue to implement policies that balance risk and improve processes.

A. Risk Management for FHA Multifamily Programs

1. MIP Increase

As part of the broader efforts in the Office of Housing since the start of this Administration, FHA has taken a number of comprehensive steps to improve its risk management capabilities and processes. These actions were carefully crafted to balance the mission of FHA and its role in the broader credit marketplace. FHA Multifamily provided critical liquidity to the marketplace during the recession and during that time (from 2008 to 2011) FHA volume increased five-fold. The GI/SRI funds provide financing for the FHA multifamily and health care loan guarantee programs, as well as several very small specialized loan products. These accounts also continue to hold a sizable portfolio of single family loan guarantees (HECM, condominium, and rehabilitation loans) insured prior to FY2009 when responsibility for new lending under these programs was transferred to the Mutual Mortgage Insurance Fund. Given the unprecedented increase in the number and dollar volume of loans insured under the GI/SRI, particularly with respect to market rate loans, the Department implemented premium increases for programs in the GI/SRI. This was the first premium increase in 10 years for these programs. Also, private capital is returning to the multifamily lending marketplace. We want to encourage this private capital to continue to return. In order to do this we need to be sure that our FHA products are not underpriced relative to what is available in the private market.

The MIP increases range from 5 basis points for 223(a)(7) refinancing to 20 basis points for 221(d)(4) new construction or rehabilitation activity. The increase premiums will have no impact on either development costs or rents. And, as the Department monitors the programs, the impact of implementing the proposal, and the interest rate environment, the Department will consider adjusting the premiums as appropriate. Also worth noting is that premiums for affordable housing projects (such as those with HUD rental subsidies and low income housing tax credits, as well as those insured under FHA risk-sharing programs) were not increased.

Cohorts 2012 and 2013 Mortgage Insurance Premium Comparison

Multifamily Programs	Cohort 2012 Annual MIP	Cohort 2013 Annual MIP [1]
Apartments NC/SR (221d4)	0.45%	0.65%
221 d3 NP coop owned apts. (221(d)(3)	0.80%	-
Apartments Refinance (223(a)(7) & 223)(f)	Both: 0.45%	223a7: 0.50% 223f: 0.60%
241a Supplemental loans for Apts. (241)(a)	0.80%	0.95%
HFA Risksharing	0.50%	0.50%
GSE Risksharing	0.50%	0.50%
Other Rental - includes sec. 207MHP, sec. 231 and sec. 220	0.50%	0.70%
Tax Credits	Non-risk-sharing: 0.45% Risk-sharing: 0.50%	Non-risk-sharing: 0.45% Risk-sharing: 0.50%

It is important to note that the elevated role FHA is currently playing in the market is temporary. The new premium structure in these programs brings FHA's pricing more in-line with the private mortgage insurance industry and enables more robust private competition while continuing to ensure sufficient levels of available capital in these sectors. The increase in premiums also reflect new realities—the Multifamily annual book of business is five times greater than it was just 3 years ago, and the risk profile has changed dramatically. FHA's multifamily apartment portfolio is now more than 50 percent market rate by unit count and 70 percent by unpaid principal balance (UPB), which adds a new component of risk, and a need to take steps to ensure the future viability of the portfolio. These risks are not yet fully captured by historical claim and default trends because they are too new to have matured as risks to the portfolio. Further, because of historically low rates, it is likely that we will own these risks for an extended period of time given the unlikelihood that borrowers will refinance out of historically low rates and may have difficulty refinancing when interest rates rise over time.

2. Loan Committees

FHA Multifamily has also implemented a new loan committee approval process, aligning Hub and Program Center commitment authority and practice to ensure consistency in underwriting throughout the regional offices, as well as to provide a platform to share best practices. Loan committees at the Hub and National levels provide oversight for high risk transactions in the multifamily insurance program, based on loan size and a project's number of units. Loan committee approval processes are standard practice in the lending community and are an important tool to prudently manage credit risks and ensure the integrity and stability of the GI/SRI insurance fund. The Loan Committee has also proven to be an effective tool for increasing communication and a more consistent FHA platform.

3. Large Loan Policy

The Department has implemented more stringent underwriting and owner experience requirements for large loans, generally over $40 million for new construction and $50 million for existing refinances. This policy addresses the risk of "single point failure" by more conservative loan ratios for large market rate loans and a higher threshold of owner experience and financial strength. The Department's Large Loan Policy mirrors other industry best practices but still provides attractive leverage and terms. Our volume after implementation of this policy has seen a mod-

est decline in the number of market rate new construction loan requests, and an overall safer book of business for loans underwritten to its requirements.

4. Revisions to Loan Documents: Increasing Accountability For Borrowers and Lenders

The Multifamily documents have been revised for the first time in decades to reflect modern day lending practices and to provide more accountability for both Borrowers and Lenders participating in Multifamily FHA programs. The documents now more clearly set forth contractual responsibilities and obligations of all parties and will enhance the Departments ability to enforce against parties in violation of business agreements. This will improve the ability of the Department to intervene more effectively to execute workouts for projects in contractual or financial violation, thereby mitigating the potential risk of claim and further protecting FHA exposure to loss.

5. Project Capital Needs Assessments (PCNA) Enhanced Guidance

The Department has published guidance incorporating industry feedback on how owners should conduct capital needs assessments for projects insured under FHA programs. The guidance aligns physical inspection standards for various programs and offices within HUD; ensures sufficient funding for replacement of building components, particularly for older properties; and addresses FHEO Accessibility issues.

6. Breaking Ground: Complete in all Multifamily Office and Delivering Results

Breaking Ground created extensive tools to monitor and access credit for Multifamily insured loans. Tools include a stronger credit review of borrowers; an early warning system that targets loans early in the process that do not meet FHA underwriting criteria; and a dashboard monitoring tool that monitors accountability of field offices; and establishment of a queue in order to more efficiently manage workload and provide greater transparency to lenders. Breaking Ground has produced results. Survey results demonstrate that staff morale has improved in the majority of field offices, with over 83 percent of HUD multifamily staff believing that the program helped their office become more effective and efficient. Almost 90 percent of staff now feel encouraged to come up with new and better ways of doing things. In terms of processing efficiency improvements, offices that had large application backlogs prior to Breaking Ground have begun to methodically clear out older applications, evidenced by the number of applications in process for over 90 days dropping from 191 to 50 in just seven months. In addition, offices that began Breaking Ground without a large backlog have begun to meet aggressive application processing time cycles established by the Office of Multifamily Housing. The Department will continue to track these metrics and look forward to reporting on these results.

7. Sustaining Our Investments: A Multifamily Asset Management Sister Initiative to Breaking Ground

The Department has launched Sustaining Our Investments, an initiative that focuses on Risk Based Management of the portfolio allowing project managers at both the Headquarters and field level to focus day to day operations on managing at-risk loans in the portfolio. Risk based reports keyed on financial and physical risk triggers direct project managers to act early on potential problems with particular assets. The first step in this initiative is completing a full ranking of FHA's entire multifamily market rate portfolio.

8. Low Income Housing Tax Credit Pilot

The Department launched a new program to facilitate the underwriting of FHA insured loans on transactions that include Low Income Housing Tax Credit equity. The pilot provides a more efficient delivery system for affordable housing by focusing on training Senior Underwriters to process loans that meet specific qualifying criteria and risk characteristics. The Tax Credit Pilot program will enable HUD to better meet our goals to finance affordable rental housing. Focusing on refinance and repair of existing properties, the Tax Credit Pilot offers a streamlined process and a staffing structure that meets industry best practices and allows HUD to focus on critical risk-based underwriting. In September, the program was expanded from a limited pilot geography to nationwide. I am pleased to report that we will endorse the first two loans under the program within the next month. These two loans were completed in less than half the processing time of our conventional program structure. With nearly two dozen loans in the pipeline under the Pilot program, we expect to see similar outstanding results using this new tool for financing and preserving affordable housing.

B. Legislative Requests

As part of the Fiscal Year 2013 Budget, HUD is seeking legislation to facilitate lending to small multifamily properties which are an important provider of affordable, but unsubsidized, housing for low and moderate-income families. According to the 2010 American Community Survey, nearly one-third of renters live in 5 to 49 unit buildings. These buildings also tend to have lower median rents than do larger properties: $400 per month for 5 to 49 unit properties as compared to $549 per month for properties with 50 or more units. Because they are expensive to finance, particularly in this environment, these properties are at risk of divestment.

HUD is proposing two legislative changes: first, changes to the Section 542(b) Risk Share program that would allow the Department to explore flexibility with the 542(b) Risk Share program to work with experienced affordable housing lenders to make Risk Share loans to small properties; and second, changes that would allow Ginnie Mae to securitize risk share loans under Section 542(b).These changes would allow HUD to enter into Risk Share agreements with qualified lenders—such as well-capitalized Housing Finance Agencies or Community Development Financial Institutions—that have demonstrated experience making loans to support affordable housing and neighborhood stabilization. Under these Risk Share agreements, qualified lenders could make refinance, acquisition or rehab loans available to small (5 to 49 unit) properties. Lenders approved by Ginnie Mae could then securitize those loans on the secondary market, increasing the availability of capital for more multifamily lending. HUD's proposal to improve the resources available to small building owners is part of the Department's broader commitment to rebalance the Nation's housing policy to support rental housing and neighborhood revitalization. These changes will provide small property owners with the same access to our Risk Share program as other multifamily property owners currently have. As Federal and State budgets shrink and the need for quality, affordable rental housing is on the rise, it's critical that we support small businesses who are finding solutions that work for families and for local economies. We look forward to working with Congress to ensure the availability of these unsubsidized, affordable housing units.

HUD is also pursuing legislative authority to allow Ginnie Mae securitization for 542(c) Risk Share loans. The 542(c) program currently serves State and local housing financing agencies whereby FHA "shares the risk" but allows the HFA to set the underwriting standards and monitor the loan. This proposal is strongly supported by the HFAs because of the long-term structural collapse of the municipal bond market that has severely constrained HFAs' access to capital and substantially increased HFAs' cost of capital.

V. FHA Health Care Programs

FHA has steadily provided liquidity in the market during times of economic constriction. Combined with historically low interest rates, FHA has seen exponential growth in this area. FHA issued a record number of $6.5 billion in commitments in Fiscal Year 2012. FHA's health care programs for hospitals and residential care facilities (nursing homes, assisted living facilities, and board and care homes) have helped private lenders fill the gap left with the shrinkage of the conventional finance resources. And while this market seems to be rebounding, we continue to expect high levels of mortgage insurance activity for Fiscal Year 2013. As of September 2012, the FHA's portfolio of health care loan guarantees had an unpaid principal balance of $29.0 billion on 2,957 loans and counting.

A. Evolution of FHA HC Programs—Balancing Risk and Improving Processes

The increased activity within FHA's health care programs have brought in positive risk management changes to both balance risk and improve processes. Given the unprecedented increase in the number and dollar volume of loans insured under GI–SRI, in Fiscal Year 2013, premium increases for FHA's General Insurance and Special Risk Insurance health care programs were instituted to protect capital reserves and increase the stability of the insurance fund. With the premium increases, FHA Health Care loans are priced more appropriately to encourage the return of private capital while, at the same time, continuing to ensure sufficient levels of available capital in these sectors.

In FHA's Office of Health Care Programs, weekly loan committees are held to review and approve loan submissions and to monitor health care industry trends and risks. By implementing proactive asset management using early intervention monitoring tools, the Office of Health Care Programs succeeded in maintaining very low claim rates in both health care facility mortgage insurance programs in Fiscal Year 2012.

LEAN Business Process Reengineering has also played an integral part in streamlining business operations within FHA's health care programs. Despite volume in-

creases, LEAN Processing improvements reduced loan processing times while increasing risk management efforts. Revised program requirements and documents were established to enhance accountability for borrowers, operators, and lenders. To further manage risk in the health care portfolio, in areas of large risk concentrations, such as insuring portfolios of multiple health care facilities, reviews are conducted at both the corporate and individual loan levels. In the residential care facility mortgage insurance program, implementation of a Master Lease Structure to cross-collateralize properties not only works to improve the overall risk profile of FHA's health care portfolio, but ultimately reduces claims.

The Office of Health Care Programs is in ongoing collaboration with HHS, CMS, and State public health departments to support efforts to ensure quality of care for the most vulnerable populations. Also, by incorporating State survey inspection results, cost reports, and data from other Federal and State agencies into FHA's underwriting and asset management procedures, the shared utilization of data and cross-collaboration has been instrumental in keeping health care claim rates low within FHA.

B. Legislative Request

As part of the efforts of FHA's Health Care programs to strengthen communities by addressing specialized financing needs, HUD is seeking passage of the language in the THUD Appropriations Bill to permit rural Critical Access Hospitals to be eligible for FHA insurance.

We are appreciative of the Congress' long standing support for Critical Access Hospitals by amending Section 242 to permit these important facilities to be eligible for FHA insurance, and hope that this language will be approved to allow Critical Access Hospitals to continue to be eligible for FHA insurance.

The efforts of FHA's Health Care programs are essential in achieving the Department's mission of strong, sustainable, inclusive communities and quality, affordable housing and services for all Americans.

VI. Conclusion

Mr. Chairman, there are real signs of recovery in the Nation's housing market. Given the progress we've seen—and FHA's central role in that progress—it's clear that FHA has fulfilled its intended role in the Nation's housing finance system. It has allowed millions of American families to benefit from home ownership and affordable rental options. It has ensured much needed liquidity in the Nation's mortgage finance markets. And it has acted as a vital stabilizing force when an economic crisis precipitated by the housing market could have resulted in this country's second Great Depression. Our job now is to be good stewards of taxpayer dollars and ensure FHA can continue be a source of opportunity and access to home ownership for future generations. We are committed to that goal, and we look forward to working with you to achieve it.