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SUSTAINABLE HOUSING FINANCE: PERSPECTIVES ON REFORMING THE FHA

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND INSURANCE
OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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SUSTAINABLE HOUSING FINANCE: PERSPECTIVES ON REFORMING THE FHA

Wednesday, April 10, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON HOUSING
AND INSURANCE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Randy Neugebauer [chairman of the subcommittee] presiding.

Members present: Representatives Neugebauer, Luetkemeyer, Royce, Miller, Capito, Garrett, Duffy, Hurt, Stivers; Capuano, Velazquez, Cleaver, Sherman, Sinema, and Beatty.

Ex officio present: Representatives Bachus and Waters.

Also present: Representatives Carney and Green.

Chairman NEUGEBAUER. Good morning. The Subcommittee on Housing and Insurance will hold a hearing today entitled, "Sustainable Housing Finance: Perspectives on Reforming the FHA." This is our fourth hearing on the FHA, a very important part of our economy and of the housing market.

I will just remind everybody that we will have 10 minutes of opening statements on either side. And with that, I will recognize myself for an opening statement.

As I mentioned, this is our fourth hearing on FHA and we have learned a little bit along the way. One of the things that we have learned is that FHA was not immune to the housing crisis and that their mortgage portfolio has been problematic to the point where we learned that their fund is basically underwater.

It has a negative equity and the President just released his budget today which indicates that the American taxpayers may have to put as much as $943 million, nearly a billion dollars, into that fund.

And we also heard from people saying that FHA had kind of moved beyond its initial charge, that it had expanded into markets and to territories it had not been before.

We also learned that some people felt like FHA was, in many cases, being used as a vehicle for doing housing policy, sometimes to the detriment of FHA, and maybe sometimes to the detriment of the housing market.

What we also learned, as we were looking to bring the private sector back into play for mortgage housing finance in this country, is that the pricing that FHA is using on its mortgage insurance in

many cases was very difficult to compete with, particularly since the American taxpayers are the ultimate backstop.

We have had a number of witnesses say that FHA reform is probably needed. There hasn't been a lot of reform to FHA in a number of years.

And one of the things that I think House Republicans, and I think this committee, are committed to is having a robust housing finance market in our country, which is sustainable.

Because we believe that if you have a sustainable, robust housing finance market in this country, then you will also have a more sustainable housing market in this country, and that is very important to the American people.

Some of the people who got mortgages, who shouldn't have gotten mortgages, could have been victims in this circumstance, but I think in many cases, the real victims of the housing crisis were those people who had been making their mortgage payments, or maybe they paid their house off and were counting on the equity in their house for retirement or to send kids to college.

And because of the market conditions and what happened, those housing values went down and those people were as much of a victim as those folks who got mortgages which maybe shouldn't have been made.

So, I think that this is an important hearing today. We have, I think, additional stakeholders. We have tried to have as many stakeholders in this process as we can because, ultimately, the goal here is to begin to look at some legislative language and policy that we think accomplishes the goal of making a sustainable housing finance market in this country.

And we want to make sure that we bring all of the stakeholders in place because it is important that we get it right. The ultimate goal here is to get this right.

We look forward to hearing from the witnesses who are here today. I think we have a great panel and we are certainly looking forward to them.

And with that, I yield back my time, and recognize my good friend, Mr. Capuano, the ranking member of the subcommittee, for his opening statement.

Mr. CAPUANO. Thank you, Mr. Chairman.

I want to thank the members of the panel for being here today. I particularly want to welcome Mr. Kelly, who grew up in my neighborhood. We did lose him to a small State named Delaware or something. It is this little State somewhere along the Atlantic Ocean, but he is welcome back.

And my understanding is he is still registered to vote in my district. Don't worry about it, Mr. Kelly, nobody will change here as long as you vote the right way, of course.

I just want to say that I actually want to thank the chairman. I think this panel today—I have read pretty much all of the testimony and I know pretty much where most of your organizations stand.

I actually think this is going to be the most informative panel we have had, and the most thoughtful discussion, I am hoping. I am looking forward to it.

I think that is the end of my opening statement, because the truth is I want to hear from you. I want to engage in some discussion.

I think we all agree that we want to make some changes to the FHA and I think we need to have a discussion about the specifics and the details of what should change, and what shouldn't, within those parameters, which maybe today is not the day for full details, but at least some general parameters.

So I am looking forward to it and, again, I want to thank the panel for coming. I look forward to your testimony. I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And, now, the vice chairman of the subcommittee, Mr. Luetkemeyer, is recognized for 2 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman, for this important hearing.

While this conversation may be difficult at times, it is in the best interest of our country and the American people to closely examine FHA and to make responsible reforms to this Nation's housing finance system.

I continue to be troubled by the fact that FHA seems to have grown well beyond its original mission. Loan limits are high. The number of insured mortgages has surpassed 7 million nationwide.

So the question is, can we find ways to reform the system? During a recent hearing, FHA Administrator Carol Galante made it clear that she would be supportive of seeing the loan limits, which now stand at $729,000, decrease.

FHA was created to serve low- to moderate-income borrowers who were creditworthy. That mission appears to have changed as FHA's book of business continues to grow.

I firmly believe that we need to advance legislation that not only returns the mission of FHA to its original purpose of serving those creditworthy borrowers who need access to the housing finance system, but also one that shifts risk away from American taxpayers and allows for more participation in the private market.

Last week, former FDIC Chairman Sheila Bair had an article in the Wall Street Journal which said, "Regulators let big banks look safer than they are" and it talked about the modeling of themselves and how they look at—when they look at their capital asset ratio.

And it shows that the megabanks, the big banks, kind of fudge the numbers a little bit whenever they put some of their more risky assets at less than the actual value and concerns that we have about them and that part of those investments are mortgage-backed securities.

So, again, we are playing with fire not only within the housing system itself, but also with investments in our financial system as well.

I think it is essential that this committee work to return FHA to its original mission and to ensure that U.S. taxpayers are not the ones left footing the bill for these risky endeavors.

I look forward to hearing ideas from the panel on how to reform the system into one that is safer and follows the tenets of its own lending and underwriting.

And, with that, I yield back, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman.

And, now, the ranking member of the full Financial Services Committee, the gentlewoman from California, Ms. Waters, is recognized for 3 minutes.

Ms. WATERS. Thank you very much. I welcome the committee's continued attention on FHA and I am pleased that we are hearing from a number of key industry participants today.

Today's hearing is the fourth hearing focused on FHA this year, and I welcome each of the witnesses to the committee.

Since its inception in 1934, FHA has insured home loans for more than 37 million American families. For many of these families, FHA was the only home financing option.

And while FHA has been put under considerable strain during the housing crisis, it served an important countercyclical role and ensured the continued availability of mortgage credit.

Now that the housing market has stabilized, FHA's footprint has been reduced, as we have heard from witnesses during previous hearings, and I am pleased that FHA has taken a number of important steps, including multiple premium increases, to strengthen themselves, which has helped lead to FHA's strongest books of business on record in 2010 and 2011.

The release today of the President's Fiscal Year 2014 budget will, undoubtedly, return attention to the financial solvency of the Mutual Mortgage Insurance Fund (MMIF) and whether HUD may need to borrow funds from the Treasury, a situation, I might add, that we won't know for sure until the end of this fiscal year.

There are bipartisan steps that we can take right now that would help address the solvency issue. I recently introduced, along with the ranking member of this subcommittee, Michael Capuano, bipartisan FHA solvency legislation that passed this committee unanimously last year, and which subsequently passed the House with over 400 votes, something that does not occur in this body very often.

So I want to take this opportunity to urge my colleagues on the other side of the aisle to join us in quickly passing this legislation and sending it to the Senate.

Among the key reforms contained in that legislation is indemnification authority, which FHA Commissioner Galante included in her list of recommendations to this committee in mid-February.

One other point that is cited in Mr. Thomas' testimony, and that I believe deserves repeating, is that FHA continues to have significant resources, sufficient to pay 30 years' worth of expected claims on its portfolio.

The Fiscal Year 2012 actuarial review showed that the total capital resources of the Mutual Mortgage Insurance Fund at the end of Fiscal Year 2012 were estimated to be $30.4 billion.

As Mr. Thomas' testimony further notes, it is also important to keep in mind that the requirement that FHA hold 30 years' worth of expected claims is 30 times more than what is required of banks, which are only required by the financial accounting standards to hold 1 year to reserve.

I want to highlight this fact in particular for those of my colleagues who believe that FHA should operate more like a private company and be subject to accounting and other rules that apply to the private sector.

Once again, I want to welcome the witnesses to today's hearing, and I look forward to examining more closely the ideas set forth in their testimony. I yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentlewoman.

Now, the gentleman from California, Mr. Royce, is recognized for 1 minute.

Mr. ROYCE. Thank you, Mr. Chairman.

The President's budget, which is going to be released later today, stands as a reminder of the risk posed to the American taxpayer if the financial solvency of the FHA is not addressed.

And for us here today, it is an opportunity to start to turn the corner and talk about returning private capital to the mortgage insurance market.

So my hope is that our witnesses will outline how the FHA can operate with a clearly defined mission that complements, instead of competes with, private credit enhancements.

If that can be done, it is going to facilitate a sustainable housing finance system for the United States. And the FHA, of course, as we all know, has a key role to play for first-time and low- to moderate-income borrowers.

But where we can unleash private capital, we should. And it is in the best interest of the taxpayer and our housing economy to do so.

I yield back the balance of my time.

Chairman NEUGEBAUER. I thank you.

And I have my interpreter here, the ranking member, and he has been making sure that I pronounce the next person—Mr. Carney, is recognized for 1 minute.

Did I say that right?

Mr. CARNEY. Thank you, Mr. Chairman. I want to thank you and the ranking member. Don't listen to the ranking member in pronouncing my last name though; you are not going to get it right.

I just thank you for the opportunity to welcome one of my friends from Delaware, Kevin Kelly, who is here on the panel today. I have known Kevin for a long long time as an advisor, as a friend, and as an expert in housing in our State.

As many of you may know, Kevin worked for one of the giants in housing in our State of Delaware and in our country, Leon Weiner—who passed away many years ago—a former president of the National Association of Home Builders, and I think the building has a bust of him outside of it.

I have learned a lot from Kevin over the years on housing issues. He used to be the president of the Home Builders Association of Delaware. There was a time in a former life where I served as the acting director of public works for the largest county in our State, and we worked very closely together.

I want to thank Kevin for all the work that he has done for our State, and he is now moving up as one of the vice presidents of the National Association of Home Builders, for all the work that he is doing and thank him for coming to be part of this panel today.

And I yield my time back. Thank you.

Chairman NEUGEBAUER. I thank the gentleman.

And I had an opportunity to know Leon Weiner as well. He was a great American, a giant in the housing industry.

I now recognize the gentleman from California, Mr. Miller, for 2 minutes.

Mr. MILLER. Thank you, Mr. Chairman.

If you look at the design of FHA, they were intended to play a countercyclical role, and in this downturn, that is exactly what they did as the private market withdrew, they moved in.

Now, without a doubt, some of the worst years FHA has on the books are 2007 to 2009, and that is when they really ramped up to fill the void made by the private sector.

The problem is that when they entered the market, they were not prepared for it. Their underwriting standards were not as they should have been. The premiums were not adequately adjusted in a timely fashion.

But if you ask, did they do what they were intended to do, they did. The nice thing about what is happening today is you are seeing a recovery in the housing market. In my specific district, I am seeing people getting back to work because of that recovery.

So, now, we look and say, what did FHA do that really restructured the way they were going, and in 2010, former FHA Commissioner Stevens created a risk management office. And, in doing that, he basically minimized some of the risks that were coming in the future, but he didn't do it as rapidly as some wanted him to do, but I want to praise him for what he did.

What we are experiencing now in the recovery, I think you can say was partly due to the efforts of FHA. Now, I am not defending them, saying that they did a great job and they did what they should have done. They did what they should have done at the right time. They didn't do it in the right fashion.

So how do we look at restructuring what they do in the future to make sure that their mission is appropriately managed and the risks they are taking on at a time is appropriate risk?

The latest actuarial review made it clear that FHA was not fully prepared for the strain that it faced during the downturn, and I don't think anybody on the panel is going to say they were prepared for it.

But did they do their job on operational structure? I think they did because they were designed to be countercyclical, but they weren't prepared for the measures that they were implementing and the full risks they were taking on.

But as we return to a robust marketplace, we look for the private sector to come in and take over the job that the FHA has done and let's hope that happens in a rapid fashion.

I yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentleman.

And now, the gentleman from New Jersey, Mr. Garrett, the chairman of the Capital Markets Subcommittee, is recognized for 2 minutes.

Mr. GARRETT. Thank you, Mr. Chairman, for holding this important hearing.

Reforming FHA must be a top priority of this committee. And I agree with each and every one of the points you raised: that we must stabilize FHA; clearly define its mission; reduce taxpayer exposure; and ensure that it is run well and run like an efficient insurance company.

But I would add one more point to the priorities. We must also make sure that the government's scorekeepers provide the American taxpayer with an accurate picture of the risks that are assumed.

To do this, the first thing you must realize is that there is no such thing as a free lunch when it comes to a government program. The costs are inevitably borne by the taxpayer.

And people are beginning to realize that not only is government costly, but also that it costs more than they initially thought. The burden of government rarely comes in under budget.

So the typical narrative of government programs gone bankrupt should come as no surprise. However, it defies common sense that the Mutual Mortgage Insurance Fund, according to Administration officials, actually makes money for the government. Only through the alchemy of government accounting can you transform a mortgage portfolio, figuratively led into gold, and still remain true to the law.

This free money comes courtesy of the Fair Credit Reporting Act of 1990 (FCRA). Under FCRA, cooked accounting rules, the cost of Federal mortgage insurance it determined it's risk on the basis of its subsidy cost including the risk that the borrowers default on its mortgages.

The subsidy cost represents, in present value terms, the amount the loans are expected to earn or lose over their life. But the rub lies in the fact that FCRA uses the interest rates on Treasury securities to calculate this cost. This assumption fails to account for market risk or systemic risk. So unlike fair value accounting, which apparently incorporates a premium for market risk, FCRA fails to reflect the true cost of FHA-backed mortgage insurance.

Unfortunately, the Administration has strongly resisted the move to fair value accounting, instead clinging to this dangerous fiction of FCRA and this alchemy.

So to bring a ray of sunshine to Federal budgeting, you must require the Administration to account for Federal loan programs on a fair value basis.

I do hope the Administration will finally wake up to the unfortunate economic reality we are in, and much like FHA, free lunches do end up costing a lot more than you expect.

And with that, I yield back.

Chairman NEUGEBAUER. I thank the gentleman.

And now, the gentlewoman from Ohio, Ms. Beatty, is recognized for 1 minute.

Mrs. BEATTY. Thank you, Mr. Chairman, and Mr. Ranking Member.

I join my colleagues today as we continue the examination of the Federal Housing Administration, specifically looking to the future as we anticipate the necessary reforms for improving FHA's long-term financial position, for refocusing the agency on its mission to increase mortgage assurance for first-time buyers and low- to moderate-income households.

I think looking at the past history of the great benefits that FHA provided to the housing market and the economy as a whole, during the past several years, it has been, in my opinion, undeniable

that the FHA has been an integral part of the housing recovery and the market as a whole.

And we could not, in my opinion, function without its presence. So I look forward to hearing your testimony and how you can be helpful to assure that we don't lose sight of the original mission of FHA.

Thank you, Mr. Chairman, and I yield back.

Chairman NEUGEBAUER. I thank the gentlewoman.

I ask unanimous consent that all members of the Financial Services Committee who are not members of the subcommittee and who have joined us today will be entitled to participate in the hearing.

Without objection, it is so ordered.

Now, it is my pleasure to introduce our panel today: Mr. Adolfo Marzol, vice chairman of Essent Guaranty, Inc; the Honorable David H. Stevens, president and chief executive officer of the Mortgage Bankers Association; Mr. Gary Thomas, 2013 president of the National Association of REALTORS®; Mr. Kevin Kelly, first vice chairman of the board of the National Association of Home Builders; Ms. Sarah Rosen Wartell, president of the Urban Institute; and Mr. Clifford Rossi, executive-in-residence and Tyser teaching fellow at the Robert H. Smith School of Business, University of Maryland.

I thank the witnesses for being here, and with that, Mr. Marzol, you are recognized for 5 minutes.

STATEMENT OF ADOLFO MARZOL, VICE CHAIRMAN, ESSENT GUARANTY, INC.

Mr. MARZOL. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to testify today on, "Sustainable Housing Finance: Perspectives on Reforming the FHA."

My name is Adolfo Marzol, and I am vice chairman of Essent Guaranty, a private MI company. Just a little background on myself, my parents came to the United States as Cuban refugees in 1961. They bought their home with an FHA loan. My mother actually still lives in that home today.

I bought my first home with a 5-percent-down mortgage from Fannie Mae, fortunately, with private mortgage insurance. And I do think my family's story mirrors so many, where access to housing finance has made a tremendous difference in our lives.

Essent was formed in 2008 in the depths of the crisis. We are dedicated to prudently continuing to provide access to mortgage credit. We are guided by the fundamental belief that truly private capital will take credit risk without explicit or implicit guarantees is something that would be needed and valued in our housing finance system.

We believe private MI, backed by strong capital and a reliable payment of valid claims, offers the market a product that effectively mitigates risk. It can be accessed by lenders of all size. It integrates smoothly into the functioning of the mortgage market, including TBA securitization.

And we think if government provides backstops in the market, private MI provides an effective alternative between either all taxpayer credit risk or no taxpayer credit risk.

We are pleased that our business approach has been validated by the market. Since we actually began writing insurance in 2010, we have grown to be about 10 percent of the new private mortgage insurance being written.

Our entry has been part of a broader renewal of a resilient industry which, importantly, is demonstrated through the ability of both new entrants and legacy companies to raise capital of over $10 billion since 2008, and nearly $2 billion just this year.

Investor interest in providing capital to the U.S. MI industry appears to be quite strong, which should enable companies like Essent to do more.

FHA helped our Nation through the crisis by expanding its role when private markets were distressed, and despite differing views regarding the eventual balance between the private and public roles in the market, we think there is widespread agreement that the role of private capital should be expanded from its present state, and taxpayer risk can be reduced.

The balance towards private has definitely been improving. We think it can continue to improve without loss of access for ready borrowers by steady, incremental use of private MI.

We support a future role for FHA, but transitioning to a more focused mission of providing access to homeownership for creditworthy borrowers who are not adequately served with private MI.

And, today, we really come with four key recommendations: Number one would be to address the long-term solvency of FHA on a foundation of provisions similar to those that were adopted by the House last Congress in H.R. 4264, the FHA Emergency Fiscal Solvency Act of 2012, including additional authorities HUD has requested to address solvency, and we believe should also include setting prudential limits on seller concessions, a policy change HUD has proposed, but not implemented.

Number two, we believe solvency should be addressed while moving toward a mission-focused footprint for FHA, simply because taking non-mission risks to address solvency needlessly increases taxpayer risk and creates incentives to serve borrowers that can be privately insured.

Number three, we would like to urge beginning to explore a different relationship between private MI and FHA not as competitors, but as partners that make sure the market is covered. As partners, private insurance should play as large a role as possible, and FHA should be a complement that expands access where needed.

And one approach to build a partnership is credit risk-sharing with private MI by FHA. Risk-sharing approaches should be tested through pilots, as FHFA has directed be done at the GSEs, targeting risk-sharing transactions on $60 billion in GSE mortgages to contract taxpayer risk this year.

And, finally, we would ask for support for appropriate recognition of the value of private MI when regulators establish the final Dodd-Frank mandated risk retention rules and continued recognition of MI in Basel III capital rules for banks.

Appropriate recognition for the risk-mitigating benefits of MI will avoid needless business going to FHA when private MI works well.

Thank you for this opportunity to share our views, and I welcome your questions.

[The prepared statement of Mr. Marzol can be found on page 59 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

And, now, Mr. Stevens, you are recognized for 5 minutes. Thank you for being here.

STATEMENT OF THE HONORABLE DAVID H. STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MORTGAGE BANKERS ASSOCIATION (MBA)

Mr. STEVENS. Thank you. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to offer MBA's perspectives on FHA reform.

The MBA represents the entire real estate finance industry, but given the circumstances facing FHA in the single-family market, my oral statement will focus on that sector. My written testimony includes our views on FHA's critical role in multi-family rental housing as well.

FHA has never played such an important role in the housing market. Today, it is the dominant source of mortgage finance for borrowers with low downpayments and those without high incomes or inherited wealth.

Many of these are first-time homebuyers, young families looking to put down roots in a community, and they are a segment that must be served if we are going to grow our economy and sustain the housing recovery.

Since the onset of the housing crisis, when FHA's books suffered like everyone else's, the agency has taken a number of steps to address losses in its single-family portfolio: raising mortgage insurance premiums; increasing downpayment requirements for certain borrowers; eliminating the approval of loan correspondence; raising lender net worth requirements; reexamining reverse mortgage policies; and establishing the Office of Risk Management.

By making these changes, FHA has moved swiftly to protect taxpayers and the fund. The credit profile and performance of the 2010 to 2012 portfolios demonstrates the effects of these changes.

For example, the average FHA credit score for 2011 was 696, up from a historical average closer to 650. More importantly, these books are projected to contribute significantly to the economic value of the fund over the next several years.

Looking ahead, we believe further programmatic changes at FHA must balance three priorities: restoring financial solvency; preserving FHA's critical housing mission; and maintaining the agency's countercyclical role.

We continue to work with our members to develop additional policy changes regarding FHA's future and we will certainly share those recommendations with this panel as they get completed.

There are a number of steps this subcommittee could take to further strengthen FHA and promote the return of private capital. Loan limits could be lowered from the levels that were necessary at the height of the housing crisis.

Downpayment requirements could be adjusted to mitigate for other risk factors like low credit scores. Risk-sharing is another

idea that if done prudently, could potentially meet all the objectives I have just listed.

Similarly, risk-based underwriting could further reduce FHA's credit risk by targeting areas of risk-layering. However, the consequences to FHA's traditional borrowers on each of the above suggestions could be significant if FHA employs overly stringent controls.

Finding the right balance is absolutely critical. Many lenders in recent years have tightened their standards beyond FHA's minimums. FHA may need to lock in some of these overlays as appropriate. This would protect FHA from any erosion in standards as market conditions evolve.

Also, in recent years, FHA has increased its oversight and enforcement of agency-approved lenders. To be clear, as FHA Commissioner, I initiated tighter controls and enforcement procedures that shut down irresponsible FHA lenders. When warranted, this was certainly the right thing to do for the fund.

The key is finding the proper tolerances and communicating them clearly to market participants. When lenders are forced to operate their businesses to near perfect standards, they will operate well inside of those published standards.

Right now, credit is far tighter than anyone has experienced in decades. There may be families with good credit willing to put down substantial downpayments who are being frozen out of the market because the risks of making any mistake are simply too great and the rules of the road are unclear and often contradictory.

When lenders don't know whether FHA will demand indemnification or cancel the government guarantee on top of the potential they may face substantial financial penalties because the goal posts have been moved, they will, quite naturally, only lend to people with perfect credit and limit financing options for FHA's targeted population.

Mr. Chairman, we need to strive to clear up the uncertainty in our real estate finance system. We need a system where homeownership is a doorway to opportunity and borrowers can once again feel safe, confident, and secure in their loans, but also a system that thrives in an environment that encourages a competitive, responsible marketplace so business can grow.

That includes not just FHA, but also examining the future of the entire housing finance system. Ultimately, all stakeholders want the same thing: a fully functioning market that relies most heavily on private capital with a limited, appropriate role for Federal programs.

A stable, sustainable FHA program must be part of that system. Thank you for the time.

[The prepared statement of Mr. Stevens can be found on page 78 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman.

Mr. Thomas, you are recognized for 5 minutes.

STATEMENT OF GARY THOMAS, 2013 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS® (NAR)

Mr. THOMAS. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for this opportunity

to testify on behalf of the 1 million members of the National Association of REALTORS® who practice in all areas of residential and commercial real estate.

My name is Gary Thomas. I am a second generation real estate professional from Villa Park, California. I have been in the business for more than 35 years and have served the industry in numerous roles. I currently serve as the 2013 president of the National Association of REALTORS®.

Throughout the course of my real estate career, I have witnessed the vital role that the Federal Housing Administration plays in providing access to affordable homeownership.

Over the past 5 years, FHA's role has been more critical than ever as it sustained housing markets nationwide during the worst economic crisis of our lifetime.

NAR recognizes the challenges that FHA is facing today and the concern about risk to the taxpayers. FHA has taken a number of significant steps to immediately replace their reserves, including raising premiums 5 times in the last 2 years, increasing risk management controls, and raising downpayments.

We believe these changes are substantial and will continue to improve FHA's financial condition. However, there are additional reforms that we believe will further enhance FHA and protect the availability of mortgage credit to millions of American families.

Today, FHA is constrained in its response to economic conditions and its own financing standing. We support legislation to provide FHA with flexibility to change program requirements when necessary to protect the fund. These include greater flexibility on setting premiums, changing loan policies, and other programmatic changes.

As a tool in its risk management arsenal, FHA should continue improving its oversight of lenders. We support legislation that provides FHA the authority to seek indemnification from direct endorsement lenders, and the ability to quickly terminate a lender's ability to originate FHA-insured loans.

There are a number of other proposals that have been suggested, which NAR believes are worthy of discussion. These include lowering the guarantee, and creating a risk-sharing model with private mortgage insurance companies. NAR does not currently have a policy on these proposals, but is actively reviewing them.

We would benefit from additional information about the proposals and their impact on the FHA, consumers, and the housing markets. To summarize, the National Association of REALTORS® supports reforms that strengthen the FHA fund. And we look forward to the return of a vital, robust private market.

NAR remains concerned about changes that would cause disruption to the housing market. Now is not the time to lose sight of FHA's mission for the sake of encouraging greater private equity, which will return on its own when extenuating factors, such as regulatory uncertainty around issues like QM, QRM, and Basel III are resolved.

We applaud FHA for continuing to serve the needs of hard-working American families who wish to purchase a home. And we stand in support of its mission, its purpose, and its performance, particularly in the times of a national housing crisis.

On behalf of the National Association of REALTORS®, thank you for the opportunity to share our thoughts on how we can work together to ensure that FHA maintains its critical role for American homeowners. And I look forward to taking any of your questions at the appropriate time.

[The prepared statement of Mr. Thomas can be found on page 99 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman. And now, Mr. Kelly, you are recognized for 5 minutes.

STATEMENT OF KEVIN KELLY, FIRST VICE CHAIRMAN OF THE BOARD, NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)

Mr. KELLY. Thank you, Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee. I appreciate the opportunity to testify here before you today. I also wish to thank my Congressman, Congressman Carney, for being here today, and thank him for his service to this Congress and to our State.

I am a homebuilder and developer from Wilmington, Delaware, and serve as first vice chairman of the National Association of Home Builders. NAHB supports efforts to improve FHA. We understand that this is not a simple undertaking, and change to FHA programs cannot be separated from the larger discussion of reforming the complex housing finance system, including future reforms to Fannie Mae and Freddie Mac.

While the recent FHA actuarial report is troubling, and deserving of congressional oversight and action, NAHB urges Congress to proceed carefully. Although there is no question that the housing finance system needs to be reformed, the contributions that FHA has made during this economic downturn underscore the need for a government backstop to both the primary and secondary mortgage markets.

As we have learned, private institutions have been unable or unwilling to meet the housing capital needs of homebuyers. Without government support for home purchasing and refinancing, the Nation's mortgage markets will grind to a halt in times of economic stress and uncertainty, throwing the economy into recession.

FHA has become the primary source of mortgage credit for first-time homebuyers, minorities, and those of limited downpayment capabilities, as other sources of mortgage credit have disappeared. The program has been essential for the Nation's economic recovery. FHA's share of the market jumped from 3 percent during the housing boom to a high of 30 percent early during the housing crisis.

Nearly 80 percent of FHA's purchase loans have been for first-time homebuyers. This dramatic shift is evidence that FHA is performing its mission of providing a Federal backstop to ensure that every creditworthy American has access to stable mortgage products.

NAHB believes that the private market should be the primary source of mortgage financing, but that market is currently extremely limited. While such conditions prevail, it is appropriate for FHA and other federally-backed programs to play a larger-than-usual role to keep our economy afloat.

FHA also plays an important role in financing of multi-family rental housing, especially now during the economic crisis. Such fi-

nancing is particularly valuable in small markets where Fannie Mae, Freddie Mac, and other market participants are less active.

FHA is now in danger of exhausting its multi-family commitment authority before the end of the fiscal year. It is vital for Congress to provide an additional $5 billion in commitment authority to prevent the programs from shutting down this summer.

With Fannie Mae and Freddie Mac directed to reduce their respective multi-family businesses by 10 percent over the next year, we face a severe reduction in multi-family financing for reasons unrelated to market conditions. NAHB believes the Congress should look at FHA and its policies in an effort to ensure the program is on sound financial footing.

While we have cautioned against the piecemeal approach to address housing finance reform, we have supported individual reforms aimed at providing the FHA with immediate tools to better manage risk and to protect the insurance fund. FHA must be modernized so the agency can operate more efficiently and effectively.

It has been constrained both by Congress and HUD, which has impeded the agency's ability to operate in a manner that evolves with the developments in the private market. FHA must be freed from bureaucratic restraints to develop a results-oriented culture. NAHB believes that this can be accomplished by restructuring FHA as an independent government entity within HUD.

In addition, a number of other changes to the single-family programs have been proposed recently, including risk-based pricing, risk sharing, and reduction in the FHA loan guarantee. These proposals merit exploration.

NAHB believes that any modification should be analyzed in the context of other changes that have occurred or may occur both within FHA and in the broader housing finance market. NAHB stands ready to work with you to achieve reforms that will provide much-needed stability for the Nation's housing sector, while ensuring FHA's future role as a source of mortgage financing, particularly in difficult financial times. Thank you, Mr. Chairman.

[The prepared statement of Mr. Kelly can be found on page 50 of the appendix.]

Chairman NEUGEBAUER. Thank you, Mr. Kelly. Ms. Wartell, you are recognized for 5 minutes.

STATEMENT OF SARAH ROSEN WARTELL, PRESIDENT, THE URBAN INSTITUTE

Ms. WARTELL. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to testify about FHA.

I am focused today on steps that Congress can take now to improve FHA's financial health by strengthening its ability to manage risk and mitigate loss. You can help the agency to better protect taxpayers with additional loss mitigation measures.

Some of these measures won broad bipartisan support from this Chamber just last year. I urge you to enact these now rather than let more time pass while costs that could be avoided continue to mount.

At the same time, I hope you will hold off on decisions about FHA's mission until the design of the larger housing finance sys-

tem is clear. Some measures under discussion would limit access to FHA in ways that could impair its ability to provide countercyclical support to the economy, and help creditworthy borrowers.

Once we have a plan to wind down the GSEs, and bring more private capital to housing finance, while preserving liquidity and long-term financing, FHA's place in the market will be clear. Unfortunately, Congress is, at a bare minimum, many, many months away from enacting legislation to reform the broader system. And in the meantime, costs that FHA could avoid today continue to amount.

It appears no deep differences prevent you from protecting taxpayers now in taking these modest steps. One caveat: I do believe that the time is right now to bring down the FHA loan limits gradually, recognizing that the different market conditions exist in high-cost areas.

Fortunately, FHA's market share is falling on its own, and private mortgage insurance is serving more of the market, as it should. Although the credit quality of FHA-insured loans is high right now, the majority are in terms the private insurers and the GSEs will not yet accept.

As the GSEs and MI credit standards ease, FHA's market share will continue to shrink, even while its capital position strengthens, just as it has in the past, after each period where FHA fills a gap in the market.

So I urge you to take up now the provisions of the legislation passed overwhelmingly by this Chamber last year, with some modest changes I detail in my written testimony. Please also consider four additional management proposals that could help FHA to control costs.

First, you can provide the Secretary with what I call "emergency risk mitigation powers," so that he may suspend issuing insurance upon terms that are risky to the taxpayers, if he makes a finding that continuation under those terms exposes the taxpayers to elevated risk of loss, and fails to serve the public interest.

The emergency authority would be time-limited, rulemaking would follow, and Congress could, at any time, vote to disapprove the use of those emergency powers.

Second, you can direct the HUD Secretary to continuously improve its early-warning risk indicators. To my mind, the Administration's proposal regarding specific changes to the compare ratio is too timid. You can empower the Secretary to use any early-warning indicator that evidence suggests is predictive of loss, provided it is lawful and nondiscriminatory.

It shocks the conscience that FHA officials must continue to accept loans for insurance pending administrative procedures, when they know the taxpayers are being exposed to unnecessary risk from a particular lender. Of course, lenders must have a mechanism to challenge these determinations. But taxpayers, not program participants, should get the benefit of the doubt.

Third, you can authorize FHA to pilot new insurance policies to test their costs, including carefully designed risk-sharing, consistent with principles I detail in my testimony, and understand better those costs and benefits before implementation.

Finally, provide FHA with the flexibility to use insurance premiums to pay for systems, contractors, and even employees with special skills at compensation akin to the bank regulators, to strengthen its capacity to mitigate risk. It will be some time still before broader housing finance reform legislation is enacted.

The system that results will determine the role that FHA must play long into the future. In the meantime, I hope that Congress will tackle what is possible, non-controversial, and urgently needed, improvements to FHA's ability to manage risk and reduce losses. A practical bill will be a helpful prerequisite to broader housing finance system reform. I thank you.

[The prepared statement of Ms. Wartell can be found on page 114 of the appendix.]

Chairman NEUGEBAUER. Thank you. Mr. Rossi, you are recognized for 5 minutes.

STATEMENT OF CLIFFORD V. ROSSI, EXECUTIVE-IN-RESIDENCE AND TYSER TEACHING FELLOW, ROBERT H. SMITH SCHOOL OF BUSINESS, UNIVERSITY OF MARYLAND

Mr. ROSSI. Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to testify on how to reform the Federal Housing Administration.

I am currently an executive-in-residence and Tyser teaching fellow at the Robert H. Smith School of Business at the University of Maryland. Prior to my role at the University of Maryland, I spent more than 20 years at major financial institutions, managing or leading risk management functions.

My testimony today focuses on the effectiveness of FHA structure, its policies, risk assessment, and operational capabilities to ensure the long-term financial sustainability of its programs. In addition, I highlight several recommendations that would secure the financial viability of FHA, while also clarifying and sustaining its role in the housing finance system.

Unquestionably, FHA has served a critical role in our Nation's housing market by providing affordable credit to about 40 million first-time homebuyers, and other borrowers with limited resources who would otherwise have difficulty in obtaining access to credit through more traditional private sector sources.

The recent financial crisis and its aftermath underscore the importance of FHA's countercyclical role in providing much-needed liquidity and credit to mortgage markets reeling from the withdrawal of private capital during this period.

At the same time, FHA in its capacity as public steward of the $1 trillion-plus Mutual Mortgage Insurance Fund, has responsibility for maintaining the financial sustainability and integrity of that fund, which according to recent actuary analyses, has lately experienced considerable stress.

The current state of the fund can be directly attributed to a lack of clarity in the scope of its programs; mission conflict between maintaining actuarial soundness of the fund and advancing homeownership opportunities to prospective borrowers; a lack of resources to effectively identify, measure, and manage risk consistent with an insurance fund of the scale and complexity of the fund; and

a lack of systematic and proactive countercyclical policy mechanisms to guide the agency as economic circumstances change.

The question for policymakers is what changes should be made to FHA to provide the agency with the best opportunity to fulfill its crucial mission in housing, while also protecting the taxpayer? Ensuring the long-term viability of the fund, while clarifying FHA's mission, can be achieved by implementing a number of reforms aimed at addressing the contributing factors to the current challenges facing FHA.

These reforms include the following: clarifying the role of FHA vis-a-vis other market participants by requiring the FHA to adopt an area median income target to determine program eligibility, and to phase out the use of area-based loan limits.

In conjunction with establishing income-based eligibility requirements, FHA should strengthen its requirements to ensure all eligible borrowers have the best chance of staying in their homes, restructuring the FHA to provide the agency with the flexibility and tools to manage its risk.

An optimal structure for an agency the size of FHA would be to establish it within a new Federal corporation overseen by a commission comprised of the heads of the various Federal agencies with housing and mortgage responsibilities, and chaired by the HUD Secretary.

This entity would bear some resemblance structurally, in my opinion, to the Federal Deposit Insurance Corporation. Such a structural arrangement would yield a number of benefits for FHA specifically, and for housing markets generally.

A set of countercyclical policies and practices should be developed. Taking a cue from the Federal Reserve's targeting of key macroeconomic factors in developing its monetary policy, a set of policy targets for housing and mortgage markets would provide FHA with clear direction on when to expand and contract its business.

Such policy targets as local home—market home price trends, market credit spreads on mortgage securities, and other pertinent housing and mortgage metrics could provide FHA with direct feedback on the health of these markets. Permit FHA to enter into risk-sharing arrangements with suitable counterparties consistent with other market participants. And finally, provide greater pricing flexibility to the FHA, including the ability to initiate risk-based pricing of mortgage insurance premiums reflective of the inherent risk of a loan.

Without question, FHA is an essential part of the housing finance system. While maligned for the current financial challenges of the fund, it is important to keep in mind that the FHA has served this country well for nearly 80 years.

However, like many institutions, FHA has not kept pace with important structural changes in the market. The advent of securitization, and other sophisticated capital markets' risk-transfer mechanisms, have left the FHA at a competitive disadvantage vis-a-vis other market participants.

The lack of a clearly defined mission for FHA, along with potential conflict between its social and financial missions, are contributing factors to the current state of the fund. The agency requires

a number of major reforms in order to put it on a secure financial footing that would ensure its important legacy for borrowers for the next 80 years. Thank you very much.

[The prepared statement of Mr. Rossi can be found on page 67 of the appendix.]

Chairman NEUGEBAUER. I thank the gentleman, and I thank our panel. We will now go to Member questions. Each Member will be recognized for 5 minutes in order of seniority. With that, the Chair recognizes himself for 5 minutes.

Before I get into some questions, I want to just have a little poll here with the panel. How many people on the panel agree that the core mission of FHA is as a mortgage insurer, that is the core business? Would you raise your hands, please?

And if the core mission is that it is a mortgage insurance company or entity, should it be run on an actuarially sound basis? Does everybody agree with that?

I think the question then—and I appreciate the testimony—is I think every one of you mentioned the fact that FHA should engage in risk-sharing as one of the ways to get the taxpayers off the hook. Is there unanimity on that? Ms. Wartell?

Ms. WARTELL. If I may just clarify, I think that appropriate pilots for parts of FHA's business are a reasonable way to proceed, but to mandate FHA risk-sharing across the portfolio would not be something I would support.

Chairman NEUGEBAUER. I think some people mentioned a pilot program, or something like that. But one of the parts of the risk-sharing piece that has been brought up is that there has been discussion about reducing the guarantee on FHA from 100 percent to some percentage more in line with what the private market insures.

Is there anybody who disagrees with that concept? Mr. Stevens?

Mr. STEVENS. I think that is the right way of approaching a pilot like this, Mr. Chairman. The thing I would emphasize is that we have to separate the guarantee against the mortgage-backed security versus the insurance guarantee that private capital has to make up at the loan level up front.

And in the event of catastrophic loss, the way it works for VA, or even Freddie Mac or Fannie Mae, is in the event the institution ultimately fails, the guarantee still exists on the mortgage-backed security, which keeps capital flowing into the market.

Chairman NEUGEBAUER. Ms. Wartell, did you want to comment on that?

Ms. WARTELL. I just want to note that if we were to use a structure like that, Ginnie Mae would then continue to have a significant amount of counterparty risk. And so, it is very important that we—and that would be very different than for the VA portfolio, which serves a very discrete set of borrowers, with a different set of incentives.

So proceeding with real caution, as opposed to funding, would be very important for FHA to—

Chairman NEUGEBAUER. I am reminded, though, that Ginnie Mae actually does that for VA loans, and they are not 100 percent guaranteed.

Mr. STEVENS. You are absolutely correct. And I think for the most part, we all agree that a pilot is worthy of testing. I think the point that Sarah is making is that there are a fewer number of counterparties in the VA program. And FHA is widely distributed amongst a couple thousand institutions that participate in that program.

And so therefore, the ability to manage the counterparty risk for that large number of lenders which participate in FHA will clearly add some cost to Ginnie Mae, which would have to be offset in some measure, either higher Ginnie Mae guarantee fees, or some way for them to build resources, because we also know that they are fairly underresourced as well.

Chairman NEUGEBAUER. Mr. Marzol?

Mr. MARZOL. Mr. Chairman, what I wanted to offer is I think the spirit of the suggestion of the limited guarantee is a worthy one, because it is an alignment of interests between private sector and public when there is risk-taking. I just wanted to point out that the approach to risk-sharing we suggest in our testimony is a fairly well-established one.

We are risk-sharing partners today with the taxpayers when we put our first-loss insurance on loans that go into GSE securitizations. And so our proposal would be to at least try to take that approach, which is fairly well-established, and see if it can have merit, and can be utilized for some of the borrowers who are ending up in FHA. So, I just wanted to offer that thought.

Chairman NEUGEBAUER. And then, I want to go in one other direction here. One of the proposals is that we make FHA a separate entity, and possibly decouple it from HUD. Because if it is, as the panel said, an insurance entity, then it might be better served being an independent agency, building up its reserves, and pricing to build up the reserves.

But also, I think one of the witnesses—maybe it was you, Ms. Wartell—said that they needed some investment and technology, and to upgrade that. Right now, they are dependent on the normal budgetary process to be able to get the resources they need, maybe to have the state-of-the-art underwriting.

Would anybody disagree that this committee shouldn't consider looking at partitioning that entity from HUD? Mr. Marzol?

Mr. MARZOL. It is not that I disagree with that suggestion. But what is important from our perspective—because you are right, FHA is a mortgage insurer. But I think we should be clear as to whether it is a government-owned mortgage insurer whose role is to compete broadly in the marketplace, and try to serve everyone it can, or is it a government program that is supposed to help expand access where the private sector can't, and then within that framework, should be run appropriately as a mortgage insurer.

I just think that is, from our perspective, an important clarification.

Chairman NEUGEBAUER. Mr. Kelly?

Mr. KELLY. Thank you. NAHB would support an independent agency housed within the Department of Housing and Urban Development for the reasons I stated in my testimony.

It is an organization that needs to be modernized. It needs to be freed from the bureaucratic constraints that currently hamstring

the organization and its effectiveness. So we would support its independence, but it should be housed within the Department of Housing and Urban Development.

Chairman NEUGEBAUER. I see my time has expired. I now recognize the ranking member, Mr. Capuano, for 5 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman, and again, I want to thank the panelists. So far, the testimony and the discussion has been exactly what I had hoped for, the least ideological discussion I think I have ever heard on this committee on an important issue.

But that doesn't mean we don't have differences. It just means we are having an adult conversation, which is nice for a change. So thank you for that.

I guess the only thing—I think I agree pretty much with a lot of generalities that I have heard. Again, details are details. But Mr. Stevens, I just want to clarify one thing that you did say.

You said you want to see the limits lowered. And I don't have a problem with that. But I want to be clear about it. I want you to clarify—would you agree that there are regional differences in real estate costs, and therefore, the limit should be adjusted from one region to another?

Mr. STEVENS. Yes. Thank you, Congressman, for asking a follow-up on that question.

We clearly think loan limits are worthy of consideration. It is not that easy. We all know that it is really not a matter of risk when it comes to FHA. First and foremost, the higher loan limits are actually additive in terms of negative subsidy to the budget, in terms of how it is calculated. And it is also a very small percentage of the portfolio.

The other key point is obviously, the $729,000 is only in higher-cost markets. So it is just a handful of select markets around the country that are important—

Mr. CAPUANO. I haven't had one of them.

Mr. STEVENS. —to those markets. And the thing we really believe is important in the event loan limits are not extended, because as you know, they automatically roll back, is we need to test and find out who is going to support those markets in the absence of those loan limits falling back.

Mr. CAPUANO. I want to follow up on an important point, because I presume you are all relatively familiar with the congressional process, and how long we take to do anything. It is actually a good process.

I know it is frustrating to a lot of people, but it works well, because we don't take things like FHA and throw them out one day, and bring them in the next day. That is what it is meant to do. But because of that—and I agree with you—a lot of concerns were thrown out.

Even the risk-sharing. I like the concept. But I will be honest with you, I am a little concerned about it. I would like to see it tested in certain pilot areas to see where it should go, exactly how it should work. Conceptually, it sounds fine. Ideologically, okay, let's try it.

But I would be very hesitant, probably, about just doing it. Because we are getting into something, and we don't know where it is going to go. So for me, I would love to see some general pilot pro-

grams to try to specify and see exactly how all these new ideas work before we mess around with something that has worked so well for so long.

That being the case, it is going to take us time. And in order for me—I come from the approach that says, "Look, let's do what we can while we can. And then on the things we are not sure of, let's take some time."

Again, I think that the FHA discussion is slowly moving away from the ideological debate and into something more realistic that we can eventually work out. But in the meantime, I think it is a mistake to sit here and do nothing. Because I am watching FHA kind of slowly fade away.

The multi-housing stuff, the reverse mortgage stuff, is a real problem that we are doing nothing about because we want to do the whole thing or nothing. I feel just the opposite. I would like to get some pilot programs going in the meantime, and in the meantime, do what we can.

We had a bill last year, that I am assuming you are all familiar with, which got 402 votes on the Floor of the House. Would any of you oppose the concept of taking that bill and passing it? Again, I fully admit it is not the bill I want, but it is something we have already agreed to.

Pass that bill, and in the meantime, work on the other things that we want to try. Maybe get some pilot programs going, and move on other issues. Do any of you think that we should do nothing until we can do everything? Or do you think that we should do what we can do as quickly as we can to fix it?

I guess I would ask you, Mr. Marzol, and then just go right down the panel.

Mr. MARZOL. We are for making as much practical progress as can be made. And as I said in my oral testimony, we certainly thought the bill that passed last year, plus the additional—some additional authorities at HUD has requested a specific mention on the seller concessions. Those would certainly be progress. And if more can be done, more can be done. But we are all for progress.

Chairman NEUGEBAUER. Mr. Stevens?

Mr. STEVENS. The most recent version of the bill is very similar to the one that was introduced when I was FHA Commissioner, which also passed, I think, by 404 votes as well. There were some minor changes to it. And we would like the opportunity to be able to work with you on a couple of concerns.

I could address them now if you would like. They are technical in nature. But we do agree generally that there is opportunity to put an FHA reform proposal through in the context as you stated.

Chairman NEUGEBAUER. Mr. Thomas?

Mr. THOMAS. Yes. We are in full support of the bill that you and Congresswoman Waters have proposed. It is very similar to the one last year that we supported, and we support yours as well.

Mr. KELLY. Congressman, NAHB supported that piece of legislation last year. We think it gives—it is a platform to revisit the subject this year. But again, we would urge that FHA reform be donned in the broader context of overall reform to the housing finance system, including GSE reform.

Mr. CAPUANO. Mr. Kelly, just to clarify, and again, I agree with what you say. Getting back to the reality of Congress, you realize that broader discussion may take a long time to finalize. And a very clear question, do you think we should not do anything until we get the whole thing done? Because that is really the question we have.

Mr. KELLY. As I say, the legislation—as opposed to doing nothing, something is better than nothing. But again, a preference would be to try and work on all of the moving parts at the same time, to develop a comprehensive reform to the mortgage finance system.

Ms. WARTELL. Congressman, if there are ways in which this body can protect the taxpayers from additional losses that are agreed to today, I think it would be very difficult to justify failing to act on those now while additional costs are incurred.

So, I fully agree. There are changes that could be made. They are technical in nature. They can be quickly worked out. You should do what you can do now.

Chairman NEUGEBAUER. Mr. Rossi?

Mr. ROSSI. I embrace pragmatic change that can happen quickly, but at the same time, I am a big believer that we have absolutely no national housing policy. And for that reason alone, I think that we have an excellent opportunity to finally step back and make the changes that we need to make to make both the secondary market or what we see in the conventional conforming side, as well as on the fully guaranteed side, the right steps going forward.

So, in my opinion, quick legislation isn't always necessarily good legislation. And so, I would at least caution the subcommittee to really kind of take a closer look at those things.

Chairman NEUGEBAUER. I thank the gentlemen. And now the gentleman from Missouri, Mr. Luetkemeyer, is recognized for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman. Just to kind of follow up on Mr. Capuano's question, you all were talking about different changes. Are there things that the Administration could do right now? I know it takes a long time for Congress to get anything done. It is like watching paint dry on a wall here, what we do.

Mr. Stevens, you are an interesting gentleman to have on the panel today, having been in the Administration before and FHA. Are there things that the Administration could do now through Executive Order, through some administrative rule, that could impact this, and make a big difference?

Mr. STEVENS. There are some things. As you know, they have already done a lot that only came from the help of Congress when the ability to raise mortgage insurance premiums was initiated in this body, and ultimately went through the Senate. So that has been very helpful to the 2010, 2011, and 2012 portfolios, which are all, by all expectations—CBO, OMB, and otherwise—expected to be very profitable.

There are measures that could be done. As an example, today FHA is being further protected beyond their own guidelines by lender criteria that is more conservative than what FHA allows for. And I think one of the things that should be considered, particu-

larly as competition increases in the market, is will lenders in the broader lending community erode the credit of FHA by using the broadest scope of the FHA underwriting guidelines? Or should FHA take some measure to try to at least lock in and protect some of the credit that is being originated today?

An easy example is that FHA's minimum FICO credit score requirement is 580. Most lenders don't do FHA loans at 580. They do them somewhere in the low 600s, due to performance concerns.

That gap should be looked at closely by FHA policy experts, and it should be determined whether those should be locked in at some level to avoid the risk of potential erosion downstream as the market becomes more competitive. So there are some things that can be done by mortgagee letter that don't require Congress.

Mr. LUETKEMEYER. Ms. Wartell, in your response to Mr. Capuano, you made a comment, too, that there are some things that can be done. Are there things you are aware of, or suggestions you could make, that the Administration or FHA itself could do right now that would be impactful?

Ms. WARTELL. There are a couple of measures that FHA is pursuing right now, but that require rulemaking for them to complete, and in some cases, because program participants have objected, there has even been litigation about that.

So one of the reasons why I think some of the provisions in this legislation would be helpful is it would clarify FHA's authority to take those actions through mortgagee letter. And I would be happy to specify those. I don't have them off the top of my head.

But I do think that giving FHA more flexibility to act sometimes without regulatory procedure speeds up their ability to protect the taxpayers.

Mr. LUETKEMEYER. Thank you. Mr. Stevens, I know that in your position with the Mortgage Bankers Association, you see a lot of the housing market activity. Do you see from the actions being taken by the government regulators, or the government agencies here, that they are forcing the private market away from this by the fees or their criteria that they are using?

And if so, are there ways that we can draw—bring it back in so the private market can come back in and be effective?

Mr. STEVENS. Thank you for that question. I think it was actually referred to in Gary Thomas's testimony as well, is that the extraordinary uncertainty in the lending community, through a morass of regulation coming from multiple bodies, not that regulation is wrong, because we need good regulations in the marketplace, but it is the inconsistency, the overlap, the lack of coordination in housing policy in Washington that is really causing much of the lending industry and private capital trepidation to re-engage in the system.

If you are private equity today, you don't know where QRM is going to end up. So why would you extend credit into the marketplace, knowing the risks associated with that? There are rules coming out from multiple regulators, and there is no coordination point at all within Washington.

We have advocated strongly that this Administration could identify an individual or body to coordinate all of these policy efforts, and clearly articulate the sort of end-state, and try to move in a

coordinated fashion so that the confusion can subside, and private capital can find a pathway to re-enter the market.

Mr. LUETKEMEYER. Yes, sir? Mr. Marzol?

Mr. MARZOL. I wanted to make a comment. If uncertainty had paralyzed us, Essent wouldn't be here today, because it took getting started in 2008 to be able to be in the market in 2013.

And I would like to just, for ourselves, we think we have the capacity to do more. We think capital is interested in doing more through private mortgage insurance. I would like to give you the sense that if there is opportunity, we think at least our company, and broadly, our industry, is positioned to do more, while other private capital sources are trying to get their feet under them and resolve their uncertainties.

Mr. LUETKEMEYER. I think my time is up. I certainly appreciate everybody being here this morning. It is a great discussion. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman NEUGEBAUER. Thank you. And now, the ranking member of the full Financial Services Committee, Ms. Waters, is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. I would like to get a little clarification discussion from Mr. Thomas about the requirement that FHA has sufficient reserves to pay predicted claims over 30-year period.

The recent report released by FHA's independent actuary states that FHA's single-family insurance fund has an economic value of a negative, what, $16.3 billion? But FHA's current cash reserves total about $30.4 billion. Notwithstanding this fact, FHA's independent actuary estimates that it does not currently have sufficient reserves to pay predictive claims over a 30-year period.

Can you discuss FHA's requirement to hold reserves to cover claims over a 30-year period? How does that compare to the Financial Accounting Standards Board's requirement for the reserves that need to be held by private financial institutions? And are you aware of any other Federal loan program that has such stringent accounting requirements?

I am speculating that this is I guess, some protection with the 30-year loan. But most people refinance about every 5 years or so. So what is this? And is it time for us to start looking at a repeal of this, and do something that makes good sense?

Mr. THOMAS. If you look at it compared with the private side, it is completely wrong. So I would agree with you, that we do need to take a look at it.

We also need to take a look at the fact that the Administration, in the budget that they are proposing, is asking to take a certain amount of money to put in, if in fact it is needed. It is not needed yet. And so why in the world are we even putting that in there when it is not needed?

Also, the fund is performing extremely well, and should be—I don't think they are even going to need it, from everything that we have researched, by the time we get to the end of the fiscal year.

So, I agree with you. I don't think that we need to have that type of a requirement on the government side that isn't required on the private side.

Ms. WATERS. I know that sometimes when we begin to look at repealing certain things have replaced in law that people are very skeptical. They must have done it for a good reason.

However, they don't take into consideration everything that has happened since the law was first instituted. And I think it is time to take a look at this.

And so since I am talking to you about it, I am going to come back and talk to you again about the possibility of a review of this that would help to rearrange our reserve requirements in ways that will not in any way put FHA at risk, but rather, relieve them of a requirement that makes it appear that somehow they are insolvent, or they are in trouble.

And I just think that we should be a little bit more forward-looking than this, and not be held to this law, that perhaps does not—is not relevant at this point in time, as we look at what happens to the 30-year mortgage, for example.

Again, I said that I think people refinance, or sell, or do something every 5 years. That is an amount of time that I remembered. I don't know if that is still about the right amount of time.

Mr. THOMAS. A little longer now. But that—

Ms. WATERS. Seven years or what?

Mr. THOMAS. Yes.

Ms. WATERS. About seven—so I do think that it is worth review. Thank you very much. Mr. Chairman, I yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentlewoman. And I now recognize Mr. Miller, from California for 5 minutes.

Mr. MILLER. Thank you, Mr. Chairman. One thing Congress excels at is looking back. We really do a good job there. But if you look at the current market, and the uncertainty of QRM, Basel III, where the secondary market is going, we have created tremendous uncertainty in the marketplace right now.

There has been debate that FHA is crowding the private sector. I think the private sector is just afraid to crowd back in. They are just not coming in.

And there has been some debate that FHA should work more like a private business. But Mr. Stevens, had that occurred when the downturn existed, and had FHA worked more like a private business, and slowed our exit to the marketplace during the downturn, what would have been the result on the housing market and the economy?

Mr. STEVENS. It would have been devastating. And, Congressman, as you know, we worked closely during that period of time. There was nobody providing low-downpayment financing in the marketplace.

And quite frankly, even HMDA data for last year clearly shows that for first-time homebuyers and other demographics with low downpayments, there is no source of access to the housing finance system. As the market recovers, and its rules create greater certainty, Adolfo's point aside, I think there is clearly not the interest in private capital to engage in a way that reflects sort of a normal lending environment as we have seen over past decades.

Mr. MILLER. Even last year, you could look at the marketplace. And when you were applying for loans, FHA was one of the few out there, because the private sector just wasn't filling that void.

Mr. STEVENS. Yes. If you look at—just take for example, Fannie Mae's recent quarterly statement release, if you look at the average loan-to-value of their purchase transactions, or excluding HARP, which is in their financial statement—HARP is refinanced activity—it is in the high 60 percent range.

So there is very little financing still coming into the market outside of FHA, VA, or USDA in the low-downpayment sector. And I think that will come in with confidence around a variety of things you suggested.

Mr. MILLER. You are starting to see the private sector come back a little bit. But when you became FHA Commissioner, you took a number of steps to improve the risk management capability of the FHA. And can you help us understand how far behind the FHA was with risk management when you became Commissioner?

Mr. STEVENS. Thank you for that question. As you well know, there was no risk management role at all at HUD when I came into the FHA job. It didn't exist.

So we actually had to come to this body. We had to get an approval to get it created as an office. We had to get appropriations to create the office.

And that is one of those flexibility impediments that really makes it difficult for FHA to respond quickly in times of crisis. Because we had to go through a variety of steps, which took months, in fact almost a full year to get the Office of Risk Management established and funded so that we could create it, and to have an insurance company of any size, let alone the size of FHA, to not have an independent risk management oversight function was deplorable. And that could not have happened without the support of Congress.

Mr. MILLER. Nobody expected the collapse to be as rapid as it was, or as significant when it did occur. That was part of the problem. And if FHA had appropriate capabilities during this crisis, do you think the losses would have been much smaller than they were?

Mr. STEVENS. Yes. The budget is going to be released here any second. And I think as we look at the numbers, the two provisions that I think people are going to look at most closely is first, that the seller-funded downpayment assistance program, which actually FHA tried to stop and was sued to continue the program, will have cost the FHA over $13 billion cumulatively against what is likely to be less than a billion-dollar net loss.

And second, the reverse mortgage program also was very costly. And that was a program that they had difficulty making changes to. If you could avoid those kinds of, what I call sort of "inability to respond to risk management issues," as Sarah Wartell discussed earlier, and FHA could respond to those, there would have been a way to avoid actually any need for a draw whatsoever, had those two programs been addressed appropriately up front with their own authority.

Mr. MILLER. They played a good countercyclical role. Could they have played that part if they were much smaller than they are today?

Mr. STEVENS. No. We have come through a recession that had 34 percent home price declines from peak to trough. We had a 9 percent national unemployment rate, the worst recession since the Great Depression, the worst housing recession in anybody's history here in this room.

And FHA became sole-source provider for housing finance. Now, granted, it is well beyond what we would describe as their mission. But in the absence of FHA playing that role, I am not sure where the financing would have come from in this country.

Mr. MILLER. Dr. Rossi, you gave examples of what private companies can do, but FHA cannot. Can you give us some examples of that?

Mr. ROSSI. The one example that comes to mind as we think about the risk management—and I would applaud Dave Stevens' efforts to revitalize, or actually establish a risk management office—but I will tell you that if FHA, in my opinion, was overseen by the Office of the Comptroller of the Currency or the Federal Reserve, their Board would be under consent decrees, or for still, some of the problems that exist today for the size and complexity of the fund that they had.

There is no question in my mind that they need to—for the size of that fund, they definitely need to reinvigorate their practices around risk management. That is in my mind job number one for them to establish themselves in that critical role of being there for—

Mr. MILLER. I want to applaud Mr. Stevens for his movement on risk management, on what you said.

Mr. ROSSI. Yes, oh, absolutely. In fact, that, as a first mover on that, that was absolutely critical.

Mr. MILLER. Yes. Thank you. I yield back the balance of my time.

Chairman NEUGEBAUER. I thank the gentleman. The gentlelady from New York, Ms. Velazquez, is recognized for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Mr. Stevens, could you please explain to us, or discuss the difference between the steps taken by FHA to improve its solvency versus some of the proposals today, as increased FICO score, downpayments, and mortgage insurance premiums?

Mr. STEVENS. Let's start with the fundamental point that is going to come out in the budget, which I understand was just released. It shows that FHA will need a draw of just under a billion dollars.

That is solely the result of the 2006 through the first part of 2009 books of business. The 2010, 2011, and 2012 books by OMB, CBO, and the independent actuary for all those shows their books being very profitable, and well-managed.

And I think the result, what has made those books profitable, made them less risky to the taxpayer, is the authority that was given to them, quite frankly, to raise premium, and some overlays that were put in around putting a minimum FICO score in place that would require a much larger downpayment beyond that.

And I would say fundamentally, FHA's risk profile is a far different picture today, in terms of new loans being generated, than the kind of risk that was put on those books during those peak years.

Ms. VELAZQUEZ. So can you tell me what specific reform, if any, you believe that is necessary today?

Mr. STEVENS. I think they need greater flexibility, to Sarah's point around emergency powers, which by the way, I don't think is in the last bill that was presented. And that needs to be added.

I do think there needs to be some additional capabilities for FHA to require indemnification of lenders that clearly violate the program. I think we have to be careful in some of that indemnification language, because it could also cause additional tightening. And there is a provision in there we need to talk about. But those are components.

I think the third area is we need to think about risk-based underwriting. So rather than attach provisions that would put hard-line vigor downpayments, for example, in the portfolio, which would be a wealth barrier to access, you can accomplish a similar outcome by putting better underwriting characteristics with lower downpayments, and first-time homebuyers, that might cap, for example, the debt-to-income ratio to a lower level, so that you can ensure sustainability for low-downpayment borrowers, while not excluding access to homeownership.

Ms. VELAZQUEZ. Thank you, Mr. Stevens. Mr. Thomas and Mr. Kelly, what do you think will be the unintended consequences of implementing better work requirements than those that are in place today? Could they potentially harm the single-family mortgage market for first-time, lower-income or minority homebuyers, particularly those in high-cost areas like New York City?

Mr. THOMAS. I am from California, so I understand that, too. Yes, it could. And so, I agree with Mr. Stevens. That is what you need to take a look at, not just coming up with a minimum downpayment, or anything like that.

It needs to be looked at actuarially, as to that borrower and their ability to repay. It should not be just a hard line. That would harm the fund, and it would harm the ability of people to get into the—

Ms. VELAZQUEZ. So how do we strike that balance?

Mr. THOMAS. You are going to have to give them the flexibility to make the adjustments without having to come back to Congress to get those things implemented. They can do it if you give them the ability to do it.

Ms. VELAZQUEZ. Yes, Mr. Kelly?

Mr. KELLY. The National Association of Home Builders surveys its members on a fairly regular basis. In our recent surveys, when we asked, "What are the greatest impediments to builders selling homes?", they are telling us—and this has changed over the last couple of years—that it is buyers' access to an availability of credit.

So I think FHA has played a vitally important role in supporting the housing market during this downturn, and this Nation's economy. I think we have to move very carefully in looking at the types of adjustments that were talked about by the other speakers.

I am a builder and developer who, on the for-sale side, build to first-time homebuyers, often in lower-income, urban areas. And

quite frankly, we periodically examine and go back in those developments.

The last 120 homes or so that I have sold in two developments in urban areas in Wilmington, Delaware, none of the buyers had more than a 3 percent downpayment. And out of the 120 over the last, I think it was 4 years, last time we checked, which was about a year ago, there was one default. All those buyers had to go through very extensive housing counseling. They all had FHA insurance.

But again, I suggest that we have to do it carefully, and very thoughtfully.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Chairman NEUGEBAUER. I now recognize Mr. Bachus, the chairman emeritus of the full Financial Services Committee, for 5 minutes.

Mr. BACHUS. Thank you. Looking at this various data about the HECM program, the home equity mortgage conversion, and the reverse mortgage program, it seems like that is disproportionately affecting the FHA insurance fund.

I know there have been premium increases. But I would ask the panel, Mr. Kelly, Mr. Stevens, maybe any of you who would like to respond, are you aware of any changes to minimize FHA losses other than maybe increasing premiums? And does the industry have any—is there any consensus between, say, the agency and the industry on how to minimize these losses?

Mr. STEVENS. Congressman, as we all know, the reverse program is a very unique program for seniors which extends to a senior citizen all the principal balance, interest accrues over time, and they make no payments. The only way the program works, quite frankly, is if home prices are appreciating over time, or if you keep the draw low enough so that it can compensate for flat home prices.

The program, up until this point, did not allow for that. It was a full-draw, 30-year fixed-rate program that allowed too much of a draw up front to the senior. And when home prices didn't appreciate, it put the fund underwater, and that is what has caused this disproportionate outcome.

I actually think Commissioner Galante has made the right move in her most recent announcement that they are going to curtail the fixed-rate, full-draw HECM, in replacement for what they call the "HECM Saver Program," which is actuarially sound, at least the last time I looked at the actuarial review of that program. It reduces the draw amount.

Raising premiums really doesn't help at this point, because if the home doesn't appreciate, and you can't pay it back, you are not going to get the premium anyway. So we need to have a program which accommodates for a flatter home price market, while maintaining a program that still provides seniors access to some sort of ability to draw down their equity.

And I think that HECM Saver, and eliminating the full-draw HECM is the way to get there.

Mr. BACHUS. Mr. Kelly, do you want to make any comments? I know that home prices have started to appreciate again. That may take some pressure off. But we can't assume that will continue.

Mr. KELLY. I would just reiterate that some of the things that have been done on the overall fund, not necessarily the HECM fund, I will be honest with you, I am not that familiar with it; haven't utilized it.

But some of the things that FHA has put in place in the last couple of years—higher mortgage insurance premiums, tighter underwriting standards, recently the requirement that the MIP continues to be paid by homeowners when their loan drops below 78 percent, and the debt-to-income ratios that are currently being mandated for buyers with scores under 680—I believe are all very prudent measures that, again, will stand the fund in good stead over the long—

Mr. BACHUS. Mr. Thomas, I should be asking you, I am sure, that first question. But what are your thoughts about minimizing the loss and HECM program?

Mr. THOMAS. Those are the two areas that have caused the fund the greatest hazard. And I would agree that the most recent changes are going to do very well for the fund. And so, we support those.

Mr. BACHUS. That is reducing the draw, basically, I think, may be a sure way to say that. And should FHA be in the business of insuring reverse mortgages, given their current financial situation? Would anyone like to answer that?

Mr. STEVENS. It is a delicate subject, as you know better than anyone. The ability for seniors to particularly have access to equity in their homes is something that is important. And I do think you can do it in a sound manner.

I think FHA was limited in terms of what they could have done in the past. I think the latest move, we will prove—although it will limit the amount seniors can draw, it still gives access to the program.

I think eliminating it in its entirety is a question about public policy and support for the elderly, who own real estate, and have fewer other means to have income.

Mr. BACHUS. It is a social mission. And I think you have to decide as a matter of policy whether that—and I think if it undermines the fund, the answer has to be no, if the changes work. Would anyone else care to make a comment? Also, what you would advise us to do. Mr. Rossi?

Mr. ROSSI. Yes, thank you for asking that question. Actually, if I put myself back in the day when I was heading risk for several large institutions, one of the things that our regulators would tell us is, "Make sure you have your risk infrastructure in place ahead of any growth."

And that goes to programs like the HECM program. In my opinion, you need to go back and do the basic blocking and tackling of understanding the risk that you are taking on. And while I think that program is very important, you really have to go back and ask yourself, "Do we have the wherewithal to be able to take those risks on at this time?"

Ms. WARTELL. Congressman, I think the important thing to emphasize is what Dave Stevens said earlier, that if at the time officials at FHA in the Bush Administration, or in the Obama Administration concluded they should change the rules of certain pro-

grams, either the seller-funded downpayments, or the HECM program, if they had been able to swiftly implement the changes they wanted, the FHA fund would be positive today.

And so I think it really—I agree with Cliff about risk mitigation tools for FHA. But I also think we need to create the ability for them to protect the taxpayer by being able to act more swiftly. So the HECM program is a perfect example of the kind of flexibility that is required.

Mr. BACHUS. And if any of you have recommendations on how we can be of assistance or supply statutory language, we would welcome that.

Ms. WARTELL. Absolutely.

Chairman NEUGEBAUER. I thank the gentleman. Now the gentleman from Missouri is recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman. And I am pleased we are having this hearing. I think we need to deal with the issues that have been raised here with FHA.

Ms. Wartell, do you believe that the FHA is already independent of anything that may come out of this committee, moving in the right direction?

Ms. WARTELL. I am sorry. Absolutely. FHA, as I mentioned in my testimony, market share has already fallen as it should. And history has shown us in prior circumstances where they played a similar countercyclical role, they took a hit to the health of the fund.

In both cases, their share fell, and their solvency was restored. And there is this ability to essentially share risk intertemporally that is built into the mechanism of FHA and it is working again.

Mr. CLEAVER. The reason I asked you, is because I thought you were suggesting what I already—except I am wondering if the other panelists agree that the FHA, independent of anything we are doing, is moving in the right direction? Does anybody believes the opposite is true? I am not particularly thrilled about some of the things they are doing, but I think they are trying to correct the problem internally. I am not really sure about the cancellation of the mortgage insurance premiums when they hit 78 percent. I think that is going to send people to the GSEs. Does anybody disagree with that?

Mr. STEVENS. Congressman, I think the difference is that we have to consider, as we look at taxpayer protection, that while FHA used to cancel the premium at 78 percent loan-to-value (LTD), they still guaranteed the risk to the bondholders, regardless of loan-to-value.

For Freddie Mac and Fannie Mae, they cancel mortgage insurance if you can get an appraisal, or it amortizes down. But then, you have no more mortgage insurance on the transaction whatsoever. And if the loan goes into default, there is nothing there to back it up. So it is hard to guarantee the risk without collecting a premium for it.

The second thing—and this is more for the Builders and the ®REALTORS—I am not sure if consumers realize when they are buying a home that 15 years from now, they are not going to have to make that mortgage insurance premium, if it gets canceled when they get to 78 percent loan-to-value.

And if they don't, then perhaps protecting the taxpayer should be the first priority. It doesn't change your qualification ability. And it probably is not a decision at the point of sale. Although, again, I think that is a better question for Mr. Thomas or Mr. Kelly.

Mr. CLEAVER. Mr. Thomas, would you please address that?

Mr. THOMAS. Sure. Congressman, to my knowledge, that never comes up in the discussion when you are sitting with a potential homebuyer, as to the fact that they might be able to cancel the FHA premium at some future date.

Mr. CLEAVER. But would you agree that they probably don't even know anything about that?

Mr. THOMAS. Absolutely.

Mr. CLEAVER. So they can't bring up what they don't know.

Mr. THOMAS. That is my point. The REALTOR® doesn't explain it to them, nor does the mortgage person explain it either.

Mr. CLEAVER. Mr. Kelly?

Mr. KELLY. I would agree with Mr. Thomas. They don't recognize that is an eventuality. I don't think it is a factor in the decision-making process.

Mr. CLEAVER. Let's continue in my line of thinking about FHA moving in the right direction. Rising home prices, it is believed, are also going to very likely reduce the $16.3 trillion problem that we thought we would have for the first time in 79 years of FHA. So—

Mr. STEVENS. The budget that was just released is a re-evaluation. Although I haven't read it, I think we will find in the budget that what changed it from billions of dollars of expected loss to the current budget, which looks at it being less than a billion dollars, I think the home price changes are obviously a key driver there.

And that also lowers what we call "severity costs" to FHA, because when a home goes into default and it sells in a rising home price market, that loss per foreclosure also ends up being less. I think both of those variables will likely be significant in what ultimately ended up being a much smaller loss than what was expected several months ago.

Chairman NEUGEBAUER. So my final question is, if the entire panel believes and even with the actual report from November which said we were going to have a problem, that FHA is moving in the right direction. Is there any concern that tinkering with the FHA now that it is moving in the right direction, might create problems that don't even exist today?

Mr. ROSSI. I would just venture to say that we may be more lucky than anything else at this point that home prices are rising, and so the fund is down to maybe $1 billion or so, as opposed to getting any place, the right changes that they need to be made so that the sustainability of the fund is there for any kind of housing price market that we come up against. So that is my perspective on it.

Ms. WARTELL. But Congressman, I think that there are two sets of changes. There are changes that will give FHA the ability to better manage its risk, which are the kinds of changes that I think you find every single member of this panel strongly supports.

And then I think there are another set of changes which could have the effect of limiting access to FHA and whether those limits are appropriate or not is very hard to know, because we don't know

what the policy framework for the rest of the housing market is going to look like when all of these changes come to there. So I think it is really important to act as quickly as you can on the things where there is consensus and make sure that we are doing the rest of those reforms in the context of broader reform.

Chairman NEUGEBAUER. Good point.

Thank you. And I thank the gentleman. Just a point of clarification in the budget's number for the President. This is actually an increase of what was in the President's budget from last year. It doesn't actually make any representation of what the actuarial numbers are at this particular point in time.

So I think sometimes, we have to make sure we are talking about the same numbers. I now recognize Mr. Garrett, from New Jersey, for 5 minutes.

Mr. GARRETT. I thank the chairman, and I thank the panel again. First of all, let's start this way. Is there anyone on the panel who thinks we should not be as transparent as we can with the American taxpayer as far as the risk that FHA potentially poses to them? Good.

So we know that collectively, when we are talking about investors in the private sector, we want to make sure that we protect the investors by having appropriate accounting standards for them, so they know what they are investing in. Is there any reason, does anyone suggest that we should not then have appropriate accounting standards for FHA, have them account for their books like any traditional insurance company would?

Ms. WARTELL. Congressman, I think the question is, what is appropriate for the taxpayer, and I think the rules that are embedded in the Federal Credit Reform Act are designed to accurately account for the cost taxpayer actually could bear.

And I think there is a concern that former CBO Director Bob Reischauer, the Center on Budget Policy Priorities, and many others have mentioned about potential changes to the Credit Reform Act in ways that could essentially inflate the cost that the taxpayers might incur from potential risks in a way that could be inconsistent with actual costs to the government.

Mr. GARRETT. So would you say that the initial subsidy estimates that FHA has given over the years have been accurate and transparent to the taxpayer and accurately reflect the risks to the taxpayer?

Ms. WARTELL. I think that the taxpayer generally has all sorts of contingent liabilities, costs from the Social Security fund and from Medicare and many other different—

Mr. GARRETT. But let's just focus here on FHA for a moment. We can fix those on another day. Are they accurate as far as what they have been doing at FHA, in protecting that in a transparent and accurate manner over the years?

Ms. WARTELL. I think FHA has generally been as good at predicting loss to a mortgage insurance fund as the private sector, actually probably better, but I take your point that it is very hard to know how housing prices and economy and unemployment will vary.

Mr. GARRETT. So, let's take a look at that. Does anybody disagree that they have been fairly accurate? Mr. Marzol?

Mr. MARZOL. Mr. Congressman, the comment I would make on the issue of mortgage credit risk, particularly with low-downpayment borrowers, is that the future outcomes depend a lot on what happens to the economy, home prices, and jobs.

So there is uncertainty about those future outcomes. If the economy and jobs are good, the mortgages should perform fairly well. One of the tools that we use, and I am not an expert in GAAP or government accounting, but as a businessman, a tool that we use a lot is stress-testing our portfolio.

It is not just assuming that times are going to be good, but it is asking ourselves, what will it look like if times are bad, including if they looked like the Great Recession that was—

Mr. GARRETT. And does FHA do that now?

Mr. MARZOL. Not, there are in the actuarial report, there are downsides—

Mr. GARRETT. Right.

Mr. MARZOL. —scenarios provided, and that is something that is just—people we try to look out a lot.

Mr. GARRETT. So that is one thing that they are not doing as well as you would suggest, as you are doing. The other area is not incorporating a premium for market risk. And before I go to you, Mr. Stevens, let me just throw up some numbers to put this in perspective, so we can show the chart.

If you really squint at that chart, this is from CBO, it is from 1992 to 2011. Just to poke off some years, this is the initial subsidy estimate recorded as provided in the budget appendices from the CBO, in the first chart. And the next chart shows latest re-estimates as provided in Fiscal Year 2013 credits supplement.

What do these charts show? To Ms. Wartell's comment, yes, they show that FHA was predicting, and each year from 1992 to 2011, but basically, it is a negative number, which means the effect on the budget is that they would be ahead of the game, right? By $852 million, in 1992, to 6 billion, 738 million dollars in 2011. How close were they to their predictions in all there? Well, let's see.

They were wrong in every single year. That is not a great track record. They were off by $205 million in 1992. In 2011, they were off by 3 billion, 376 million dollars. On a scoring level of one out of 100, zero isn't that great, is it? So I would not say the level of accuracy is great. And yes, the private sector may not be that good at this, but if the private sector had a zero accuracy level, they would be out of business.

But when the Federal Government has a zero accuracy level, the American taxpayers are the ones who foot the bills. So I would hope that we could agree, as was said at the beginning, that we all want more transparency and one of them would be to go into CBO with success.

Or others have suggested doing corporate premium for market risk and also we go into fair value accounting, which perhaps along with what Mr. Marzol has also suggested, give us a more, true reflection of what this is affecting and the cost to the American taxpayer. With that, I see my time is up now.

Chairman NEUGEBAUER. I thank the gentleman. And now the gentlelady from Arizona, Ms. Sinema, is recognized for 5 minutes.

Ms. SINEMA. Thank you, Mr. Chairman. Actually, I don't have any questions. And that might make me the most popular member of the subcommittee today, actually.

[laughter].

Thank you.

Chairman NEUGEBAUER. With that, we will recognize Mrs. Beatty for 5 minutes.

Mrs. BEATTY. Thank you, Mr. Chairman, and Mr. Ranking Member. First, let me thank all of the panelists who joined us today as we look at your perspectives on how to reform FHA. We have obviously had a number of these meetings, and we have had our Director from FHA come in and provide us highlights.

In listening and reviewing your materials, I think many of you, and especially as I look at the document from you, Mr. Kelly, let me thank you for the third paragraph on page 2, where you give us the 80-year history and what FHA has gone through from the Great Depression.

And in that last line, you talk about it being a testament to its ability to meet the mission in these difficult economic times, that we weren't there 4 years ago, when we were really in the height of it.

So my question to you or any one or two of the other panelists, is I take a more laser focus on the mission of FHA, to serve those low- and moderate-income homeowners, often first-time homeowners, and then for fun, let's just throw in what happens when we look at a 620 credit score, or lower, because that is the population in my district, when I look at having the richest and the poorest.

For you, the question is, let's focus on those who are on the lower end. In looking at, and listening to the testimony, what I would like to hear is, what one specific thing, assuming we are all in favor in keeping it to its mission, and only tweaking it, what is the one thing that you could give me, that you would support or suggest to us, that we do for those low-income folks who aren't going to have another opportunity?

And certainly, we know that the housing market spurs the economy and I don't think anyone here, and I don't want to speak for you, would be against saying that this low- and moderate-income, first-time homeowner, who has had some life crises, as many of us might have had, should still deserve to have that opportunity to be insured for a home. What is it that you would do from your perspective?

Mr. KELLY. I would tell you from my own experience, as I shared with the committee earlier, our company has built and developed a lot of first-time entry-level housing. We have used the FHA programs, often in conjunction with State and local programs.

What I have viewed again, and this is anecdotal more than scientific, my own experience is the fact that in every instance where we have done these programs, there has been a mandatory housing counseling component to that. I think you are also going to find that probably, fairly universal, with State housing finance agencies, and their first-time homebuyer programs across the country.

And I think if you look at the rates of foreclosures in those programs with State housing finance agencies, their portfolios are per-

forming very well. I think it is very important that those who are unaccustomed to the obligations and responsibilities of buying a home and maintaining that home, understand what the total cost and real cost are for it, so they can prepare.

Unfortunately, when they don't get that counseling, many only think about the fact that they have to pay a mortgage. They have no idea that mortgage payments are going to include taxes and insurance escrows, and they don't think about the cost of heating and cooling and maintaining the property.

Mrs. BEATTY. Thank you.

Mr. KELLY. The one thing I would say to your quote, what I think is at the root of your question is that recessions are hardest on those with the least means. And so if you are in a State that is dependent on manufacturing, for example, Ohio and Michigan, they got particularly gutted by the automobile industry. You find yourself unemployed, and you don't have a lot of wealth in the bank to survive that period of unemployment.

Your credit score is going to be hurt harder than those who have large amounts of inherited wealth, or relatives who help you out through those times. We do need to find a way to ensure that we have responsible access for consumers who don't have those kinds of resources available to them, to get the advantages of homeownership, which is good for society, good for the community, and good for the economy.

I think there are solutions that provide access. And one suggestion is to consider ensuring that they have a debt-to-income ratio that allows for enough residual income after their fixed costs to cover their liabilities, not necessarily allow 50 percent back into that income ratio, which could be unsustainable for a person who has other marginal means for paying their monthly obligation, lowering that debt-to-income ratio to a more reasonable level, while not excluding them entirely from the opportunity for homeownership. It is a balance of sustainability and access that is critical to the market.

Mr. THOMAS. I would follow up too, Congresswoman, that we want to make sure that FHA remains available and affordable to all classes. We don't want to see the increase in cost or downpayments that will disenfranchise these borrowers. If it was raised to 5 percent down, that would disenfranchise 300,000 borrowers a year.

Chairman NEUGEBAUER. I thank the gentlewoman, and now the gentleman from Mr. Ohio, Mr. Stivers, is recognized for 5 minutes.

Mr. STIVERS. Thank you, Mr. Chairman, and I want to thank the witnesses for being here today. I also want to thank the chairman for calling this very important hearing on how we can shore up FHA because to my fellow Ohio Congresswoman, FHA does have an important mission, and we want to make sure they are there to perform that mission.

But I have heard some things that you have pretty much all agreed on today. Number one, and I will call it a consensus, there seems to be some mission conflict, and there seems to be a discussion about when it is appropriate to deal with that. FHA has to do a better job of allocating resources to risk management. They need to at least look at risk-sharing.

They need to do something with risk-based pricing and they need to do something with their risk exposure and decide what level they feel comfortable insuring, and I think all these things together can move us forward, and so I am going to ask some questions on each one of those things in turn, with regard to mission conflict, and my predecessor just talked a lot about how important FHA is to low-income folks.

But I saw a recent study from the George Washington University School of Business which showed that 30 percent of FHA loans were going to families making more than 115 percent of the average median income, and I guess something looks like it is missing to me, and I will ask this question to Mr. Stevens, but why does FHA not have an income limit?

There is a limit on the home price, there is a limit on lots of things but if it is really a mission geared toward low- and moderate-income buyers, why don't we look at some type of cap on how much folks can make and be eligible?

Mr. STEVENS. Congressman, I think virtually every economist—and I am not one—would agree and have advised over time that income is a better measure for an FHA program. The challenge is if we want a market that functions, income is one of the most disputed measures when it comes to backing up representations and warrantees.

So if you put a minimum income, a maximum income level for a particular community, and an underwriter and a lender is underwriting, a self-employed borrower who has a part-time job as well, and there is a dispute ultimately upon default, as to what income level was used, that can become a problem.

And I would just tell you anecdotally, I ran a large financial institution, and I brought 20 underwriters into a room. I handed them each a thick pair of tax returns, a set of tax returns. I had them all underwrite the same return separately, and then put their number on the white board in front of the room. And I had about 12 different numbers out of that group of underwriters.

And that is the risk we ultimately create for the lending community to advance capital. I think loan limits have become a proxy for that.

Mr. STIVERS. Can I ask you, so you are the head of the Mortgage Bankers Association, do your members use income in their underwriting?

Mr. STEVENS. They do.

Mr. STIVERS. Should it be considered, maybe not a hard limit, but shouldn't it be considered as a component?

Mr. STEVENS. Again, I agree underwriting—

Mr. STIVERS. It is—

Mr. STEVENS. —the loan income level is the better and more accurate variable to ensure access to homeownership measures, and if it can be done with precision, in a way that can be implemented in the—

Mr. STIVERS. Sure.

Mr. STEVENS. —housing and system, we would absolutely be open to that.

Mr. STIVERS. Does anybody disagree that FHA should spend more time and resources on their risk management? If they are

going to do that, they need to make sure they have the money, and I would just tell you that FHA does not charge the maximum premium allowed by law.

But let's move to the next topic that relates directly to that, and that is risk-based pricing, and I do have a question, sort of for Mr. Thomas, although kind of for Mr. Kelly. A lot of people brought up risk-based pricing. Mr. Thomas, in your testimony, you talked a lot about the problem with condominiums and I recognize that problem.

But to the extent there is a problem there, would—and I know the REALTORS®, the organization you represent hates increasing FHA premiums or dislikes it. But would you rather have the ability of people who need condos to buy them at a risk-based premium, or have the current rules on condos?

Mr. THOMAS. The interesting thing is that condos actually perform better than single-family homes.

Mr. STIVERS. Sure.

Mr. THOMAS. And condos are also typically the entry point into housing. So, we need to make sure that is available to them and currently, with some of the things that FHA requires of condo associations, the condo associations are not renewing their ability to have FHA loans in their complexes. So there are a lot of problems around the FHA in the condo area, and that is just one of them, Congressman.

Mr. STIVERS. It looks like my time is up. I will yield back and hope for a second round of questions.

Chairman NEUGEBAUER. Thank you. Now the gentleman from California, Mr. Royce, is recognized for questions.

Mr. ROYCE. Thank you, Mr. Chairman. And let me start with Mr. Marzol. In your testimony, you describe a resurgence of capital to the private mortgage insurance industry, $2 billion raised this year.

What is the state of the industry? How many companies are currently offering coverage? And do you expect more capital to be raised in the near term?

Mr. MARZOL. —actually, the question comes at a good time. I think there have been some very positive developments in terms of the state of the industry, and there are six or seven, I think, active companies. I should probably go through and name them all.

Mr. ROYCE. No, no, no, don't do that.

Mr. MARZOL. I—

Mr. ROYCE. Spare me that.

Mr. MARZOL. But the question comes at a good time. The industry has, and companies have had access to capital. There is another new entrant which came into the market this year, along with Essent having come into the market a couple of years ago. Another large corporation announced the acquisition of a smaller industry company in an attempt to turn that company into a full service provider.

Mr. ROYCE. —so—

Mr. MARZOL. Our feeling is that the capital markets are open now for mortgage insurers to raise capital.

Mr. ROYCE. What is the number one thing Congress can do to ensure that capital gets off of the sidelines?

Mr. MARZOL. I think capital comes where it thinks it sees business opportunity and need. Things have been moving in the right direction, and I think the extent that Congress continues to take steps that signals that there is demand and need for mortgage insurance in the system, like the risk-sharing idea that has been talked about. Those are the kinds of things that will be very helpful to continue to bring capital to the industry.

Mr. ROYCE. You raised another issue, and it is one that I raised at the last hearing. You raised this issue on the impact of the QRM rule and Basel III capital rules on FHA's attractiveness to lenders and to banks. I am very worried that the net impact of these rules is that government policies are going to steer borrowers to the FHA and further crowd out the private markets.

So let me just ask you, what do you think needs to be done to change those proposed rules to ensure a level playing field for private mortgage insurance?

Mr. STEVENS. I think on Basel III, it would be any help that we could get, and we will make our own case, of course, to the bank. If there has been any help that we can get to persuade that private MI continues to be recognized for capital purposes, for banks, assuming that the MI is being provided by a financially sound mortgage insurance company.

And then on risk retention, actually, our view is that the thing which would be most helpful would be to actually get mortgage insurance thought about the right way in the rule. And what I mean by the right way, is that private mortgage insurance is long-term risk retention. If we could get private mortgage insurance recognized as long-term risk retention in the rule, then wherever lenders end up, potentially having to have a risk retention obligation, if they don't have the capital and balance sheet to bear that risk, we would then be able to step and be that risk retention source for the lender.

Mr. ROYCE. Okay. Thank you. I want to go to Mr. Stevens and ask a question about eminent domain, because these proposals have been under consideration in a number of States, certainly California being an example. These proposals would use the eminent domain power to seize mortgages at a deep discount, and then refinance them using FHA insurance. Should FHA be used to back loans acquired through eminent domain?

Mr. STEVENS. Thank you, Congressman. I believe strongly that the FHA should block the ability for eminent domain rules to use their insurance fund. Director DeMarco of the FHFA has said explicitly in a public statement that Freddie Mac and Fannie Mae will not be a source, as an outlet, for this eminent domain process and has gone further to say they may ultimately exclude financing being made available in those communities where eminent domain is used.

That would leave the FHA solely there to be adversely selected by these communities and that should not be allowed.

Mr. ROYCE. Do you want to jump in, too, on the QRM rule and the Basel III, Mr. Stevens?

Mr. STEVENS. I think Adolfo's point about recognizing other credit enhancements in these rules is critically important. But I don't think it is enough to recognize credit enhancements in QRM, be-

cause still the cost of capital for a government guarantor is cheaper, and so if there is a downpayment threshold, even if a private credit enhancement is recognized, that ultimate cost of capital for the private credit enhancement won't compete with a government-guaranteed credit enhancement.

So, we really need to make certain that the QRM rule is defined as equaling the Qualified Mortgage rule and not set another barrier in place that creates an additional cost for private capital to engage in the market.

Mr. ROYCE. Thank you, Mr. Stevens.

Chairman NEUGEBAUER. I thank the gentleman. The gentleman from California, Mr. Sherman, is recognized for 5 minutes, and my apologies for not acknowledging you before.

Mr. SHERMAN. You got the State right. I want to pick up on what Mr. Royce had to say. I am a bit confused on what basis—I don't know if the other side is represented here—someone would argue that private mortgage insurance is not a risk mitigant.

How is it that the folks defining both QRM and Basel III would say, just ignore this? Does anybody have any insight into how these two regulatory processes are going the wrong way? I see nothing but heads shaking and I look forward to working with you and with others on this subcommittee to try to make sure that both processes recognize the obvious, which is, if you own a mortgage that is insured, you have less risk than if you have a mortgage that is not insured. Mr. Thomas, maybe you could tell us a little bit about what it is like in the marketplace? Is PMI now thought of as a way to help, making some headway, expanding its share?

And particularly with regard to condominiums, it is difficult to get FHA insurance for condominiums. What role does private mortgage insurance play there?

Mr. THOMAS. We are not seeing the private mortgage insurance back into the market back in a big way. We would love to see it. And we would love to see the lenders back in as they were before the crisis.

But, the rules that are still out there, the QM, the QRM, and the Basel III, once those are finally finalized, I think we will then start to see the restructuring of our whole mortgage system, so that we understand where the rules are and everybody can play by them.

The problem is now, the lenders are not ready to get back into the market until they know what the game is that they have to play. And so, we are seeing just a continuing tightening of credit, both from the availability of it, to the qualification of it. I tell any of the borrowers I deal with that they are going to go through an inquisition, not a normal process.

And so, that is what the borrower is facing today. It is much more difficult than it needs to be, but a lot of it is because of the regulations and the unintended consequences of not knowing what they are going to be.

Mr. SHERMAN. Does anyone else have a comment on what is actually happening in the marketplace? Yes?

Mr. MARZOL. Just a comment. Individual markets are different, but the private mortgage insurance industry in 2012 did write $175 billion of—

Mr. SHERMAN. And that is a substantial—

Mr. MARZOL. —of insurers, and definitely were up from the bottom when we were only at one time in 2010, I think between 4 and 5 percent of the market. So we are a little bit of the invisible man of private capital in the mortgage market, but it is, it is not an insignificant sum of mortgages that are getting access to mortgage credit with private capital on them through private mortgage insurance.

Ms. WARTELL. Congressman—

Mr. SHERMAN. Yes, go ahead.

Ms. WARTELL. I think the one thing to remember is that FHA, with its premium increases has now, and for many loans, not all of them, gotten to the point where it is more expensive than many of the MI products. The real barrier, one of the real barriers for the MIs, strictly in the purchase money as opposed to refinance market, is that they are limited to what the GSEs will purchase in much of their business.

And so the dynamics here about where, how FHA market share can shrink and the MIs can grow, is not principally determined by FHA policy. There are other factors in the economy, including the regulation of the GSEs by the, in conservatorship. And so, I think we are getting—

Mr. SHERMAN. So—

Ms. WARTELL. —to a place that will be—

Mr. SHERMAN. —if I can interrupt—

Ms. WARTELL. —in that process.

Mr. SHERMAN. —but we all want to see mortgage insurance play its role in the economy. We all want to see more private, less FHA, with returning FHA to more its traditional role, but ultimately, it is the lenders and the securitizers that control this process.

And if you have the lenders affected by Basel III and QRM rules, that prefer FHA to private mortgage insurance, if you have Fannie Mae and Freddie Mac rules that prefer FHA to private mortgage insurance, then our whole goal of having private mortgage insurance return to its traditional role is distorted.

Ms. WARTELL. A level playing field is absolutely the goal and I think there is sometimes too much emphasis on making FHA change the rules to level up the playing field. And I think often it is these larger structural issues that are going to create the opportunity for us to see more private capital return.

Mr. SHERMAN. I believe my time has expired, but I look forward to working with my colleagues to try to push the securitizers and those who draft QM and QRM and Basel III in the right direction.

Chairman NEUGEBAUER. I thank the gentleman. And now the gentleman from Wisconsin, Mr. Duffy, is recognized for 5 minutes.

Mr. DUFFY. First off, Mr. Kelly, did you want to make a final comment there? I see you had your hand up.

Mr. KELLY. No, simply that I mentioned this earlier in the hearing, that in response to Mr. Sherman's question regarding what are we seeing, as I indicated, NAHB does a regular survey of its members and asks questions regarding the challenges they face in producing and selling homes, and the top of the heap at the moment is the credit access and availability and standards that their prospective buyers face.

Mr. DUFFY. Thank you. I am one who supports the traditional mission of FHA. I think it is important, however, that we balance that traditional mission of FHA with securing American taxpayers from having to step in and bail out more housing programs.

Last year, we were in the hole $688 million at FHA. We had a mortgage settlement of a billion dollars that was able to plug that hole, per Mr. Stevens' insightful comments, the budget came out with a request for $943 million for FHA, right under a billion dollars per year.

To the point, a lot of us are concerned about the solvency of the program and taxpayers stepping in and bailing out the program. I think all of you on the panel had agreed that you are in favor of some form of risk sharing, is that correct? I think Mr. Neugebauer asked that question, and you all agreed to it.

What kind of ratio do you think is appropriate? And I open it—is it 80/20, is it 50/50?

Mr. STEVENS. Congressman, there are a couple of things that I would suggest. One is that FHA already has the authority to implement a risk-share pilot and that has not been done to date for a couple of reasons, but one of which is just resources to get it going.

Mr. DUFFY. But what ratios? What kind of ratio do you have?

Mr. STEVENS. The thing that I would suggest, and a ratio is a difficult one for the pilot, but I would suggest that we need to make sure that we do it in a way that doesn't, that creates a clear market where there is not an option other than risk-sharing and the FHA for the pilot. Because otherwise, the execution will never work, and the pilot won't work, so—

Mr. DUFFY. But you—

Mr. STEVENS. —and I—

Mr. DUFFY. —start off with, what, 10 percent as a goal, or some small percentage to test the pilot before you expand it?

Mr. STEVENS. I think that is where you need to stop.

Mr. DUFFY. I want to give everyone a chance to answer, but I am a little confused on why we are asking for a pilot? Isn't our pilot the VA and isn't the VA really a pilot program for us, and it has worked? Why do we have to do another pilot? If we are talking about pilots, I wish we would have talked about pilots with regard to Dodd-Frank, not FHA.

But we have already tested it out with the VA. Why are you—it seems like we are kind of slow walking this thing a little bit when we have seen it tested, and we have seen it works. Why don't we just do it?

Mr. STEVENS. Sarah, do you want to take that?

Ms. WARTELL. Well, a couple of things. First of all, VA is a much smaller program, and although it has a much lower default rate, the borrower pool that is eligible is different. They tend to have better FICO scores and there is a set of ways in which—

Mr. DUFFY. By its very nature—

Ms. WARTELL. —the VA has indirect—

Mr. DUFFY. —the definition of a pilot, it is a smaller program.

Ms. WARTELL. It is more than a smaller program. It has very different and targeted borrowers who are eligible, and most of us would not predict that you would see the same behavior and the

same performance on a pilot that was applicable to the entire FHA borrowers.

Mr. DUFFY. What leads you to believe that?

Ms. WARTELL. Because the borrower is in VA, first of all, they are all military and eligible through their service in the military.

There are ways in which they may have lost some eligibility for other VA benefits, if they fail to perform on their FHA, which creates a different incentive for them to perform on their loans, and they also tend to be concentrated in particular markets where some of the risks that FHA has borne aren't there. So if this were expanded to the FHA's traditional markets, you may see very different performance.

That is why we would propose taking an FHA-eligible borrower, and find ways to share risk. In many loans, it is not risk sharing at all, because it is a 25 percent top loss coverage, and many of us would propose that FHA design a real true sharing of risk through the borrower, to align incentives better between the insurer and FHA.

Mr. DUFFY. I appreciate your quick answer, getting it all in there. Maybe we can continue a dialogue on it. There are some more questions I have on the pilot program. In regard to premium increases, we are at 1.35 percent, we have a cap of 1.5 percent, so we are not there yet.

But I think you all indicated that you support the legislation that passed last year which would bring us up to a cap of 2.05 percent. Do you all support raising that percentage, where you pass the 1.5 percent, something closer to the 2 percent that was in the legislation that you all said you support? Anybody? My time is up, but I am not getting called, so I am going to ask you to answer the question.

Mr. STEVENS. Congressman, the one thing I would say is that FHA, the good news is FHA has risen their premiums, raised their premiums multiple times and it wouldn't—

Mr. DUFFY. And it hasn't—

Mr. STEVENS. —they wouldn't have that—

Mr. DUFFY. —and it hasn't worked yet, we are—

Mr. STEVENS. —they wouldn't have—

Mr. DUFFY. —still short.

Mr. STEVENS. —that capability if they hadn't done it here, they just raised premiums April 1st by another 10 percent and our, and application activity was in the FHA, dropped 14 percent this last week. We are already losing share as a result of raising those.

Mr. DUFFY. A $943 million shortfall this year. So I guess—

Ms. WARTELL. It is on the HECM program.

Mr. DUFFY. Go ahead. What is that?

Ms. WARTELL. The shortfall this year has to do with losses on loans that they have already insured, and the predicted performance—

Mr. DUFFY. Are you—

Ms. WARTELL. —of the forward-looking—

Mr. DUFFY. —are you calling Mr. Stevens out for his performance at a—

[laughter].

I will yield back and maybe we can we can chat further on this at some other time.

Chairman NEUGEBAUER. I thank the gentleman, and now the gentleman from Delaware, Mr. Carney, is recognized.

Mr. CARNEY. Thank you, Mr. Chairman, and thank you for giving me an opportunity to ask a few questions and to welcome my friend Kevin Kelly at the outset. I am not a member of this subcommittee, but I have to tell you, this hearing has been great.

It has been very thoughtful, a great discussion. Starting off with your questions, Mr. Chairman, and there was quite a bit of agreement among the panelists which is not something that we often see in this hearing room, and it was really good to see, for me.

Mr. Kelly knows that we have something in Delaware that we call the "Delaware way." And when we have a problem, we kind of put our political differences aside, we get the experts in the room, and we try to figure out how to address the problem.

It seems like if we did that here, on this issue, how to reform the FHA, we could put this panel together, maybe add some other folks and you all could write legislation that would represent a consensus among your groups.

And I know we have done that in Delaware. We have done it on occasion where Mr. Kelly has led those kinds of initiatives and I just throw that out there as a suggestion, maybe to bring the Delaware way to resolve some of the differences we have around these issues here over the FHA and the reforms that are necessary.

We very much appreciate all your input. I had to leave, and I really apologize for that. I don't know if you had any discussion about the GSE reform, but I would be particularly interested in hearing your perspective on what we should do.

The President asked us, a couple of years ago, actually Secretary Geithner came here to this committee with their White Paper, which included a continuum from complete privatization to some sort of public/private partnership there, and I would be interested if any of you have some—Ms. Wartell is leaning forward. I suspect she has some views and I would her first, my friend Mr. Kelly, and Mr. Stevens, and anyone else who would like to add your thoughts on that? Thank you.

Ms. WARTELL. Clearly, it is appropriate for the Congress to remedy some of the failures of the past in the GSEs. That means that we should not have an unpriced and unpaid-for implicit guarantee.

We need the government's role to be limited to stand behind private capital, to be priced and paid for in some kind of catastrophic risk insurance fund, which will—and I think over time, that fund should stand behind a smaller portion of the market and gradually be phased out over time.

The mechanism by which private capital can stand ahead of the taxpayers in that, I think can be diverse, but they—we don't—the advances made by FHFA in creating a new securitization platform means that we can separate what the GSEs have been doing between securitization and credit enhancement, and come up with a way to ensure that there is well-capitalized entities with access to capital market mechanisms to stand ahead of the tax—

Mr. CARNEY. Does the Urban Institute have a proposed solution or on—

Ms. WARTELL. I am working on a proposal that may come out in some weeks with some bipartisan colleagues.

Mr. CARNEY. Thank you very much. Mr. Kelly?

Mr. KELLY. Thank you, Congressman. NAHB has taken a position and I will reiterate it that we believe the most effective means of benefiting the taxpayer is a comprehensive reform, both to FHA as I said earlier in my remarks, as well as GSE reform. That—

Mr. CARNEY. And we have heard that from many people who have come before our committee to do it—

Mr. KELLY. And—

Mr. CARNEY. —in a comprehensive way.

Mr. KELLY. And we always encounter the law of unintended consequences. We think the mortgage finance system in America is in need of a holistic reform. We are in favor of reforming Fannie Mae and Freddie Mac. That should be done. We think that is a paramount concern. But we, again, think FHA reform should march along at the same time.

With that said, we are emphatic in our position that it is essential that there be a government backstop, back in the primary and secondary mortgage markets to ensure continued access to credit for all homebuyers.

Mr. CARNEY. Thank you—please.

Mr. THOMAS. Yes. The National Association of REALTORS® has had a White Paper out for about 3 years on this, and I think if you read through it, you will see that we agree that there still needs to be a Federal backstop, and we need to have access to capital in any kind of a market.

But there are many things that need to be contemplated in a reform of the GSEs and we are in support of that, and if you read through our White Paper, you will see that.

Mr. CARNEY. Thank you very much, Mr. Stevens?

Mr. STEVENS. The only thing I would say is, we have a White Paper out also. All of our papers generally recommend the same relatively similar construct. In fact, the BPC is in all that—

Mr. CARNEY. So why is it so hard for us?

Mr. STEVENS. We believe strongly that we have to start taking steps in that direction, having these institutions perpetually on, in conservatorship is untenable. They are controlling 70 percent of the liquidity in the housing finance system today. The decisions they make are extraordinarily impactful.

The housing finance, both in terms of the government's role and the private sector's role and we really would encourage steps now while interest rates remain low, while the market's in recovery, to deal with the future of the state of these two institutions in an organized way, because if we fail to do so, down the road when rates rise and tinkered with guaranteed fees for legislative purposes and otherwise we will be in a much worse position.

So doing this now, we—in an organized way, is very important.

Mr. CARNEY. I see my time has long expired. I appreciate the chairman for his forbearance and I will look at your White Papers, and I may call you and we can discuss it further. Thank you very much, Mr. Chairman.

Chairman NEUGEBAUER. I thank the gentleman and I thank our panelists. I think we have had a good discussion today, with a lot

of good ideas. I would just encourage the panel and the groups that you recommend that we are—the next step in this process is to begin to take some of these ideas and to put them into some sort of an action plan, which would probably be some legislative reform.

If you have any other ideas—we don't want to just limit it to the ones that you had today. As this debate begins to unfold, if you have thoughts and ideas, we certainly would welcome them.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without objection, this hearing is adjourned.

[Whereupon, at 2:20 p.m., the hearing was adjourned.]

A P P E N D I X

April 10, 2013

Statement of Randy Neugebauer
Subcommittee on Housing and Insurance
"Sustainable Housing Finance: Perspectives on Reforming FHA"
April 10, 2013

Thank you all for attending this important hearing examining FHA's role in housing finance and potential ideas to reform the Agency. This is the fourth in a series of hearings on FHA and we intend for this hearing to inform the drafting process for a potential FHA reform bill.

In our previous hearings, we learned that FHA is nearing insolvency, putting taxpayers at risk of another government bailout; that FHA is operating far outside its historical mission, which is hindering the development of a sustainable housing finance market; and that despite being an insurance company, FHA runs its MMI fund contrary to the most basic principles of insurance.

We also learned that members on both sides of the aisle strongly support FHA's core mission of providing access to credit for lower-income borrowers and first-time homebuyers; and that notwithstanding that support, there still is a general consensus in favor of strengthening and improving FHA.

Given the fiscal and administrative challenges facing FHA, the hearing today is invaluable in assisting the Members in developing a proposal that will improve FHA, protect taxpayers, and facilitate the return of private capital in the mortgage insurance market.

Once this hearing concludes, Committee staff will begin working on a legislative framework to reform FHA. I also envision holding additional subcommittee hearings that will examine aspects of FHA's business model other than its traditional single family portfolio, including its multi-family, reverse mortgage and hospital programs. Those subsequent hearings will identify other reform ideas that will help us put the finishing touches on any reform proposals produced by the Committee.

As we embark on the legislative process, there are four principles that I believe the Committee must address. First, we must get FHA back on sound financial footing so taxpayers are better protected. Second, we must clearly define FHA's mission to ensure that the Agency is narrowly focused on serving first-time homebuyers and creditworthy low-to-moderate-income borrowers. Third, we must shift risk away from the taxpayers and into the private sector by reducing FHA's footprint and make sure the Agency is complementing the private sector, not directly competing with it. Finally, we must ensure that FHA runs its MMI Fund according to the basic tenets of insurance, including evaluating its risk according to actuarial principles and correlating premiums to actual risk.

We look forward to working with the stakeholders in the room today - and others who may not be here - to achieve these principles and put together a sensible FHA reform package. I also look forward to working with Ranking Member Capuano and his colleagues to report out what I hope to be a bipartisan bill.

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Testimony of Kevin Kelly

On Behalf of the

National Association of Home Builders

Before the

House Financial Services Subcommittee on Housing and Insurance

Hearing on

"Sustainable Housing Finance: Perspectives on Reforming FHA"

April 10, 2013

Introduction

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee on Housing and Insurance, I am pleased to appear before you today on behalf of the National Association of Home Builders (NAHB) to share our views on improving and modernizing the Federal Housing Administration (FHA). We appreciate the invitation to appear before the subcommittee on this important issue. My name is Kevin Kelly, and I am NAHB's 2013 First Vice Chairman of the Board, and a builder and developer from Wilmington, Delaware. NAHB represents over 140,000 members who are involved in building single family and multifamily housing, remodeling, and other aspects of residential and light commercial construction. NAHB's builder members construct approximately 80 percent of all new housing in America each year, and many of our builders rely on the use of the programs of the Department of Housing and Urban Development (HUD) (largely FHA's) in order to help provide decent, safe, and affordable housing to many of our fellow citizens.

NAHB supports efforts to improve FHA, and we understand that this is not a simple undertaking, yet we want reform to be approached with a certain degree of caution. Changes to FHA's programs cannot be separated from the larger discussion of reforming the complex housing finance system, including future reforms to Fannie Mae and Freddie Mac. While the recent FHA actuarial report is troubling, and certainly deserving of congressional oversight, NAHB urges Congress to proceed cautiously and not significantly alter the role of FHA programs.

The FHA was created in 1934 during the Great Depression to promote stability in the housing marketplace and has been viewed as a housing finance innovator by insuring millions of mortgage loans since its inception. In its nearly 80 year history, the agency has successfully achieved its mission at no cost to taxpayers. The fact that the FHA finds itself in this position now, as opposed to four years ago during the height of the financial meltdown, is testament to its ability to meet its mission in these difficult economic times.

While there is no doubt that the housing finance system needs to be reformed, the contributions that the FHA has made during this economic downturn underscore the need for a government backstop for both the primary and secondary mortgage markets. In times of crisis, private financial institutions have been unable or unwilling to meet housing capital needs. Without government support for home purchasing and refinancing, the nation's mortgage markets will grind to a halt in times of economic stress and uncertainty, throwing the economy back into recession.

Given the significant role that housing plays in the economy, Congress needs to take a long-term, holistic approach to housing finance reform. NAHB stands ready to work with the House Financial Services Committee to achieve such reforms and provide much-needed stability for this critical sector of the economy.

Importance of the Federal Housing Administration for Single Family and Multifamily Mortgage Financing

Since the creation of the FHA, it has had a long track record of achievement in insuring loans for over 37 million American families, many of whom would not otherwise have been able to own a home. FHA pioneered the concept of a 30 year fixed-rate mortgage and low down payments, and the nation still benefits from that program today. FHA maintains strong underwriting criteria to protect the tax payers and is intended to be self-funded through the upfront and annual mortgage insurance premiums that borrowers pay.

Contrary to the belief of some, FHA is not a subprime lender and has never required a federal bailout. Although the single family mortgage insurance program is experiencing shortfalls in its excess reserves due to the effects of the worst economic downturn since the Great Depression, FHA remains an integral part of our nation's economic recovery. Housing has led America out of every economic downturn and can do so again if the future policies regarding housing finance reform are addressed in a manner that provides liquidity for the entire housing sector in all markets.

Looking at the dramatic increase of FHA's market share of single-family mortgages over the past few years, it is clear how essential the program is for our nation's economic recovery. Since the downturn in the housing market, FHA has become the primary source of mortgage credit for first-time home buyers, minorities and those with limited downpayment capabilities as other sources of mortgage credit have disappeared. During this time, FHA's share of the market jumped from 3 percent during the housing boom to a high of almost 30 percent early in the crisis. Nearly 80 percent of FHA's purchase loans have been to first-time home buyers. This dramatic shift is evidence that FHA is performing its mission of providing the federal backstop to ensure that every American has access to a stable mortgage product. NAHB believes that the private market should be the primary source of mortgage financing, but that market is extremely limited. While these circumstances prevail, it is entirely appropriate for FHA and other federally backed programs to continue to have a larger than historical market share.

FHA historically also has played an important role in the financing of multifamily rental housing, and it is especially important now during the current economic crisis. In 2008, FHA endorsed just over $2 billion in multifamily loans (excluding health care programs), which grew to $14.6 billion in FY2012. This unprecedented increase in FHA multifamily loan volume occurred as other private market sources of multifamily financing withdrew from the market as economic conditions worsened. FHA, along with Fannie Mae and Freddie Mac, are the primary sources of multifamily financing today. Like in the single family market, the FHA multifamily mortgage insurance programs are fulfilling the function and mission for which Congress originally intended.

FHA Single Family Mortgage Insurance Programs

The FHA single-family mortgage programs are a unique and vital component of the housing finance system, providing access to homeownership for underserved communities, primarily first-time homebuyers, minorities and those with limited downpayment capabilities. During the recent mortgage crisis FHA demonstrated how invaluable their counter-cyclical role was in providing mortgage market liquidity during the country's unstable housing market system. This role has not been without costs to the FHA program as evidenced by the recent actuarial studies of the FHA's Mutual Mortgage Insurance Fund (MMIF).

Since 2010, FHA has implemented a series of policy changes, including higher mortgage insurance premiums, tighter underwriting requirements, stricter mortgage lender enforcement, and improved risk assessment all intended to strengthen the performance of the MMIF and rebuild the capital reserve ratio. These changes are the most sweeping combination of reforms to credit policy, risk management, and lender enforcement in FHA history. FHA's 2012 Actuarial Report estimates that the changes in credit policy and pricing have added more than $20 billion in economic value to the fund from 2010 through 2012.

Just this year HUD announced even more steps it will take to improve the health of the fund and expects that these measures, coupled with an estimated additional $11 billion in capital from

new business in FY 2013, will return FHA's capital reserves to a positive position within the year. Some of the measures HUD has announced include:

- Continued improvements to loss mitigation programs, including targeting deeper relief to struggling borrowers, expanded use of short sales and streamlined policies for sales of foreclosed properties.
- Elimination of the policy that allows borrowers to stop paying mortgage insurance premiums (MIP) after their loan reaches 78 percent of its original value. This policy, which went into effect in 2001, has left FHA without premiums to cover losses on loans held beyond the period after the borrower stopped paying MIP. This change will apply to new loans only, effective June 3, 2013.
- Increasing the annual MIP by 10 basis points on new FHA loans, effective April 1, 2013.
- Requiring borrowers with credit scores below 620 to have a maximum total debt-to-income (DTI) ratio no greater than 43 percent in order for loans to be approved through FHA's automated underwriting system. Loans with DTI above 43 percent will have to be manually underwritten. This is effective for new case numbers assigned on or after April 1, 2013.
- Increasing downpayment requirements on loans above $625,500 (up to $729,750) to five percent from 3.5 percent. FHA is reviewing public comments on this proposed change, no effective date has been announced. (The current high cost loan limit of $729,750 will expire at the end of 2013 and revert back to $625,500, the same as the high cost limit for Fannie Mae and Freddie Mac.)

NAHB generally has been supportive of FHA's changes to bolster the MMIF. However, NAHB strongly believes that such changes must be balanced to ensure the ability of FHA to maintain its critical mission of providing support for homebuyers. For example, we note that FHA has increased the annual MIP five times since 2010, raising the annual MIP to the highest levels in FHA's history. As of April 1, the annual MIP on a typical FHA loan (LTV less than 95 percent and loan amount below $625,500) is 130 basis points compared to 50 basis points in April 2010. Further, the upfront MIP has increased to 175 basis points. There has not been adequate time to evaluate the impact that these pricing and other FHA policy changes have had on FHA borrowers. In the meantime, Congress is also considering additional changes to FHA.

Past Legislative Proposals

Over the past couple of years Congress has taken a hard look at the FHA and its policies in an effort to ensure the program is on a sound financial footing. While NAHB has cautioned against a piecemeal approach to address housing finance reform, we have nevertheless supported individual reforms aimed at providing the FHA with immediate tools to better manage risk and protect the insurance fund without disenfranchising responsible homebuyers.

The following legislative reforms were included in bi-partisan legislation passed by the House of Representatives last Congress, and supported fully by NAHB:

Flexibility in Mortgage Insurance Premiums: NAHB has supported the ability to provide FHA with more flexibility in setting annual mortgage insurance premiums. While the aim of such flexibility would be to ensure a fiscally solvent insurance program, NAHB supports a ceiling on these premiums as a way to maintain FHA as a viable option for homeownership.

Lender Indemnification: NAHB has supported strengthening and broadening HUD's ability to ensure that mortgage lenders are required to repay the Department for losses on loans they originate or underwrite regardless of when the FHA insurance claim is paid. Under such a proposal, HUD would be given the ability to terminate lender participation in the program (for those that have a high rate of early defaults) on a nationwide basis in addition to specified local areas. Since HUD currently may only terminate a lender's authority in a specific HUD field office jurisdiction, this would help HUD effectively mitigate risks to the MMIF.

Origination of FHA-Insured Loans: NAHB has supported improving FHA's flexibility by providing authority for small loan originators to originate FHA insured loans in partnership with larger lenders, thereby enabling mortgage brokers to continue doing FHA business without having to alter their business practices or state licensing.

Early Term Delinquencies: NAHB supported requiring HUD to develop a program that analyzes all early period delinquencies and states that HUD must seek repayment by the lender for any early term delinquency that did not meet FHA's underwriting guidelines and requirements.

Risk Officers: NAHB supported the creation of a Chief Risk Officer for the Government National Mortgage Association (Ginnie Mae) in order to have financial oversight on a daily basis, rather than wait for the annual audit. Further, proposals have also codified HUD's existing practice by establishing a Deputy Assistant Secretary for Risk within FHA to mitigate mortgage risk and protect the FHA single family fund.

Annual Actuarial Reports: NAHB supported requiring HUD to provide a semi-annual independent actuarial report on the MMIF and conduct an evaluation of the feasibility of doing quarterly reviews.

Streamlining of Programs: NAHB has supported language that HUD shall conduct a study identifying unused or underused FHA insurance programs and methods to streamline, consolidate, simplify, and reduce the number of these insurance programs.

Emergency Capital Plan: NAHB supported language that required HUD to provide an emergency capital plan for the restoration of the FHA's fiscal solvency and directs the Government Accountability Office to provide for an independent third party to conduct a one-time safety and soundness review of the FHA's mortgage insurance programs and report on its findings.

FHA Multifamily Mortgage Insurance Programs

NAHB has long-supported the FHA multifamily mortgage insurance programs. These programs, notably Section 221(d)(4) and Section 223(f), have enabled the construction of needed affordable and market rate rental housing units over the years, as well as contributed to the ability of property owners to acquire, refinance, rehabilitate and preserve the nation's existing stock of rental housing. Of importance, FHA financing is often used in smaller markets where Fannie Mae, Freddie Mac and other market participants are less active, and FHA has filled the niche that local banks and thrifts have retreated from in recent years.

It is important to note that over the last two years, HUD has instituted new risk management protocols for the FHA multifamily mortgage insurance programs. The new protocols tightened underwriting requirements and created a national loan review committee. New policies were implemented for large loans, including higher standards for sponsor creditworthiness and

experience. Processes and procedures throughout the field offices have been strengthened and standardized. There is closer scrutiny on market strength and FHA presence than before the economic crisis struck.

In addition, HUD revised and tightened lender capitalization, licensing and monitoring requirements, made significant changes as part of the update of the loan closing documents, and finalized several changes to the multifamily mortgage insurance program regulations. The most recent step taken was raising the mortgage insurance premiums for programs in the General Insurance/Special Risk Insurance (GI/SRI) fund. This was the first premium increase in 10 years for these programs.

Most recently, a new Concentration of Principal Risk policy was issued describing the procedures lenders must follow to obtain prior approval for borrowers (principals) with greater than $250 million of outstanding FHA-insured debt who plan to submit applications for new loans. Under the new policy, lenders are required to conduct a complete mortgage credit review of principals who meet the threshold.

All of these actions were intended to strengthen risk management practices related to the FHA multifamily mortgage insurance programs, ensure the health of the GI/SRI fund, and attract high quality borrowers, without taking market share from the private sector or endangering taxpayers. NAHB has been actively engaged in working with the department as these requirements have been implemented. Although NAHB has not agreed with every action taken, overall we have supported HUD's objectives and have worked to ensure that borrowers and lenders understand the changes.

As important as these steps have been towards increasing risk management, the FHA multifamily field offices continue to struggle because of inadequate staffing and resources. The Office of Multifamily Housing is in the process of testing "workload sharing" among the Multifamily Hubs and Program Centers to address imbalances among staffing levels and to compensate for absences of specialized staff (such as appraisers or construction experts) needed to complete a loan review. This involves the sharing of staff resources among different offices, as well as shifting some loans from one office to another (generally in the same geographic area). The department's objective is to alleviate staff burden, improve operational efficiency and respond more effectively to customers.

Further stressing the multifamily programs at this time is that commitment authority is being used at a significantly faster pace than last year, and it is very possible that there will be a disruption in the programs early this summer unless Congress acts to authorize additional commitment authority. HUD estimates it will need $5 billion in additional commitment authority for the remainder of FY2013. Lenders and borrowers may be faced with no avenue to obtain construction financing or to refinance existing properties if FHA's authorized level of commitment authority is exhausted before the end of the fiscal year.

NAHB believes that staffing and resource issues must be addressed to ensure that the FHA multifamily mortgage insurance programs remain strong and viable. In addition, the uncertainty related to the availability of commitment authority has the potential to create great disruptions in financing important affordable and market-rate rental properties, as well as health care facilities, which are also included under the GI/SRI fund. NAHB also notes that the Federal Housing Finance Agency's (FHFA) recent announcement that Fannie Mae and Freddie Mac must reduce their respective multifamily businesses by 10 percent over the next year, together with the FHA commitment authority situation, is close to representing a "perfect storm" in that financing for

multifamily properties could become severely constrained quite quickly, for no reason related to market conditions.

Modernization of the FHA

FHA's operations must be modernized to allow the agency to operate more efficiently and effectively. In its current framework, governed by federal budget constraints and rigid statutory and regulatory requirements, FHA is sluggish and inefficient. FHA has little capacity to implement adequate operating processes, respond promptly to mortgage market developments, or pursue program and product innovations. FHA lacks experienced personnel, is unable to provide adequate staff training, and is constrained in human resources management. FHA has lagged in implementing technological improvements. The Government Accountability Office (GAO) and HUD Office of Inspector General (OIG) have identified the department's outdated financial management system as a serious impediment to the proper oversight of FHA's portfolio. Both GAO and the OIG report the need to update technology and integrate systems to enhance HUD's ability to perform required financial management functions and efficiently manage financial operations of the department.

Constraints have been placed upon FHA, by Congress and internally via HUD, which inhibit FHA's ability to operate in a manner that recognizes, complements and evolves with developments by the private sector. To continue its vital role in the housing finance arena, FHA must be afforded greater freedom from external micromanagement and political influence while developing a professional, responsive, results-oriented organizational culture and remaining accountable for achievement of its mission.

NAHB believes that this can best be accomplished by restructuring FHA as an independent government corporation within HUD, separate from Ginnie Mae, which would continue its current mission of supporting liquidity, innovation and continuity in the housing finance markets by providing mortgage insurance backed by the full faith and credit of the U.S. government. The restructured FHA would be led by a chief executive officer, appointed by the President, who would report to a presidentially appointed board, chaired by the HUD Secretary.

The Bipartisan Millennial Housing Commission (MHC) recommended that FHA be restructured as a wholly owned government corporation within HUD in its 2002 Report to Congress. The key differences between the MHC and NAHB recommendations are that MHC would combine FHA and Ginnie Mae and would have the FHA CEO report directly to the HUD Secretary. (See: Report of the Bipartisan Millennial Housing Commission, May 30, 2002, p. 45.)

While under general Congressional oversight, FHA should have the authority, without further Congressional action, to create or alter specific insurance programs in order to have the flexibility to react promptly to changes in market and other conditions. Hiring, salaries, personnel management, and procurement would be freed from current, confining federal government constraints in order to be more consistent and competitive with the private sector. FHA would be operated in a manner that does not require a federal subsidy and would allow FHA to retain revenues generated in excess of expenses to be used for mission purposes.

Additional Proposed Changes to FHA Single Family Programs

In addition to the structural, operational and programmatic changes discussed so far in this statement, a number of other changes to FHA single family mortgage insurance programs have been proposed. NAHB recognizes that additional changes to FHA programs may be necessary

as the housing finance system continues to evolve and wants to participate in the dialogue on such changes. NAHB believes that in evaluating proposals for further change in FHA programs, the modifications should be analyzed in the context of other changes that have occurred or may occur both within FHA and in the broader housing finance system. Assessing the cumulative impact of all components of housing finance system restructuring, including the interplay among housing finance sectors, should be standard protocol for accurately determining the ultimate outcome of any proposed change on FHA's mission, effectiveness and financial condition.

NAHB has not yet established policy positions on FHA program proposals beyond those discussed in the preceding sections of this statement and cannot do so until sufficient explanations and details on the additional proposals are available. Some of the single family program proposals merit exploration, including those involving risk-based pricing, risk-sharing and reduction in the current portion of the loan insured by FHA. While such changes could offer benefits to FHA and the mortgage marketplace, they also raise a number of questions and concerns, which are identified below.

Risk-Based Pricing – Calibrating mortgage insurance premiums to the risk profile of the borrower would allow FHA to better align its revenues with potential claims and thus bolster reserves. However, it would also place FHA in the position of raising the mortgage financing costs of the individuals it has the mission to serve. A key consideration in designing a system of risk-based pricing for FHA is the range and weighting of risk-factors used in determining the schedule of premiums.

Risk Sharing – Dividing the risk with private companies would reduce FHA's loss exposure and could have other operational advantages. However, it would also raise the question of FHA's exposure to adverse selection if the private companies limited their participation to the lowest risk portion of FHA's business. This concept also could reduce or eliminate participation by smaller mortgage lenders, particularly community banks, who would have difficulty meeting the eligibility criteria for the program. A change of this nature would also impact the Ginnie Mae mortgage-backed securities (MBS) program by raising Ginnie Mae's exposure to counterparty risk and would likely require significant changes at that end as a result.

Reduced Degree of FHA Insurance – FHA could also shift risk exposure to the private sector by reducing the percentage of a loan that it insures. The Department of Veterans Affairs (VA) has operated its Loan Guaranty Program in this manner with positive results. However, the VA program is restricted to a specific portion of the population, the military, and has operating features that may not be replicable at FHA. In addition, as in the case of risk-sharing, Ginnie Mae's counterparty risk exposure would increase, necessitating changes in that program as well.

Conclusion

Few things are more important to Americans than their homes. Whether they rent or own, Americans want to choose where they live and the type of home that best meets their needs. Rental housing is the choice for millions, from all ages and walks of life. For many others, the opportunity to own a home is the cherished ideal. Today, even though the housing market is still recovering from the effects of the worst housing market downturn since the Great Depression, Americans still believe in homeownership, which is why NAHB appreciates the key role FHA has played in keeping our housing market liquid, stable and affordable.

Given the significant role that housing plays in the economy, we urge Congress to take a long-term, holistic approach to housing finance reform. NAHB stands ready to work with you to achieve such reforms and provide much-needed stability for this critical sector of the economy.

Statement before the
Housing and Insurance Subcommittee
of the Committee on Financial Services
United States House of Representatives

Hearing On "Sustainable Housing Finance: Perspectives on Reforming FHA"

Adolfo Marzol
Vice Chairman
Essent Guaranty, Inc.

April 10, 2013

Introduction

Chairman Neugebauer, Ranking Member Capuano and members of the Subcommittee, I am Adolfo Marzol, Vice Chairman of Essent Guaranty, a private mortgage insurance ("MI") company founded in 2008. Thank you for the opportunity to testify today on "Sustainable Housing Finance: Perspectives on Reforming FHA."

Let me briefly introduce myself and Essent.

I was born in Cuba and my parents came to the U.S. as Cuban refugees when I was one year old. My parents purchased their first home here with an FHA loan, and my mother still lives in that same home nearly 45 years later. About 20 years later, I purchased my first home through a Fannie Mae loan with a 5% down payment, with private MI, of course. My family's story is just another example of how safe, affordable and sustainable mortgage financing plays a vital role in our society by enabling homeownership. Today I represent Essent Guaranty, a company dedicated to prudently extending mortgage credit to low down payment borrowers through the issuance of private mortgage insurance.

Essent was formed in 2008, founded by private investors with a fundamental belief that private capital would be needed to support a well-functioning U.S. housing finance system in the wake of the financial and mortgage crisis. In Essent's early days, with no end in sight to the crisis, many questioned the wisdom of starting a new private MI company. Essent continued to believe that a private mortgage insurer with the financial strength to pay claims backed by a strong contract that treats policyholders with fairness and transparency would be a valued partner to lenders, mortgage investors and taxpayers (through their ownership and backstop of the GSEs).

Essent not only initiated a new wave of private capital into the MI industry, but also contributed to the renewal of the MI product by addressing market concerns related to representation and warranties in the mortgage transaction. Our introduction of Clarity of Coverage®, a binding endorsement to the company's insurance contract, commits us to the highest standards of transparent, reliable and fair practices in MI protection, and gives insured lenders and policy beneficiaries a renewed confidence that their claims will be evaluated fairly and valid claims will be timely paid. The clarity we've brought to the MI contract has been complemented by clarification of representation and warranty obligations by the GSEs and in recent contract changes by other MI companies. Clarity of Coverage shows how private sector competition can lead a broad response to market needs.

Essent's business approach has been validated by the market. Since writing our first policy in the second quarter of 2010, we have insured $19 billion in mortgage loans. Essent writes about 10% of the new private mortgage insurance in our nation, and is doing business with hundreds of lenders, large and small, across the entire country. We continue to put our capital base steadily to work bringing private credit risk-bearing capacity to the U.S. mortgage market.

We recognize the contributions of FHA to getting the nation through the recent crisis, given the contraction of private credit that occurred in the wake of the crisis, and support a future role for FHA that returns to a more focused mission of providing access to homeownership to creditworthy borrowers that cannot be adequately served in the conventional market with private

MI. Accordingly, this requires private capital to play a larger role to ensure that creditworthy borrowers continue to be well served in the U.S. mortgage market, and private capital has firmly demonstrated its willingness to invest in the U.S. MI industry. The demonstrated ability to attract capital allows firms such as ours to support the U.S. mortgage market with increasing capacity to write more, deeper and broader MI coverage.

Reform of the housing finance system, including FHA, should move forward, guided by shared objectives which should include reducing taxpayer credit risk and expanding the role of private capital, while preserving access to homeownership for creditworthy borrowers. This can best be achieved, in our view, by (i) addressing the solvency of FHA within a mission-focused footprint (ii) leveling the playing field between private MI and FHA, including encouraging regulators to establish rules such as QM (for FHA), QRM and Basel III that do not distort the market in favor of FHA (and the associated taxpayer risk) and (iii) implementing other reforms that encourage the expanded use of private capital, including MI, without adverse impacts on credit availability and liquidity in the mortgage market. For example, credit risk-sharing by both the GSEs and the FHA with private MI can play a significant role toward accomplishing these objectives efficiently and reliably.

The Role of the U.S. MI Industry

The role of private MI is important because the potential for severe credit losses is inherent in the mortgage market at all times. Protecting policyholders by absorbing insured losses, especially when economic conditions are bad, is our fundamental role. Over the past four years, private MIs have paid approximately $35 billion in claims to the GSEs, losses that would have otherwise fallen on the U.S. taxpayer. Private MIs are projected to pay a total of approximately $50 billion to cover losses arising from the downturn. This is a success story, despite the fact that three MIs went into runoff because of losses. (Runoff means the insurer is no longer writing new insurance, but continues to pay claims under regulatory supervision). Also during the housing crisis no TARP programs were created for the MI industry and no expectations exist that MI companies will be bailed out in the next crisis. The industry is firmly private without the benefit of any government guarantees – explicit or implicit.

In the crisis, the role of the industry contracted, bottoming around 2010 when new MI written fell to 4-5% of the total mortgage originations market. Since that time, new insurance volumes have grown, rising to $175 billion (including HARP refinances) in 2012, about 9.5% of mortgage originations. This remains well below a more normal MI share of the market, historically in the range of 12-15% of mortgages originated. Despite the recent lean years, the industry continues to play a meaningful role in the overall mortgage market, with total insured loan balances of $714 billion at the end of 2012. [1]

Our industry has shown resilience, importantly demonstrating the ability to attract capital, both through new entrants and recapitalization of incumbent companies. Companies in the MI industry raised over $10 billion in new capital throughout the mortgage crisis. Two incumbent companies raised nearly $2 billion this year. With the addition of new entrants, the MI industry will have about the same number of national providers going forward as it did before the crisis. Investor interest in providing capital to the U.S. MI industry appears to be quite strong. The private MI industry continues to represent private capital actively at work in the U.S. mortgage

[1] *Inside Mortgage Finance* (February 28, 2013), and Essent estimates.

market mitigating credit risk for private investors and taxpayers every day on low down payment borrowers, and can do more.

MI coverage significantly reduces the credit risk to taxpayers on loans securitized through the GSE TBA market. For example, on the typical 5% down payment loan (i.e., a 95% LTV), first-loss MI coverage insures 30% of the loan balance, transforming the risk exposure for taxpayers to an effective LTV of approximately 67%. There is a tremendous difference in loss exposure between a mortgage that defaults at 95% LTV without MI, versus the same loan with MI. That risk reduction comes from the private capital of the MI company standing in front of the U.S. taxpayer.

One of the powerful features of private MI is its effective integration in the routine functioning of the mortgage market, including TBA-securitization. Lenders of all sizes and types can access private MI and secure the coverage at loan origination, reducing the credit risk on the loans before taxpayers backstop the risk. MI also works effectively with lenders and GSEs in the servicing of mortgage loans, including significant delegation of authority to servicers and GSEs to undertake modifications to keep families in homes or to benefit from foreclosure alternatives, such as short sales.

Expanded Role of Private MI In Housing Finance Reform

As Congress considers the path of housing finance reform, and the role of FHA within the future system, no question seems to be more fundamental than defining the relative roles of the private sector and government in the market. There is widespread agreement that the role of private capital should be expanded and taxpayer exposure to mortgage risk reduced from its present state.

Many discussions of reducing the role of government rest on the premise that the choice is one of no taxpayer credit risk or all taxpayer credit risk. Framed in this context, reform discussions have paid great attention to the return of the fully private securitization market without an explicit or implicit government backstop. These markets are, in fact, slowly re-emerging after being moribund since closing for newly originated loans late in 2007. The return of a purely private securitization market should enjoy bipartisan support because, at a minimum, these markets will be needed to play an important role in serving jumbo borrowers.

However, a robust return of private capital and reduction of taxpayer risk need not wait for the return to vitality of purely private securitization markets. In those sectors where government provides a backstop, the expanded use of private MI and similarly well-capitalized and regulated private credit enhancements provide a powerful tool to significantly reduce taxpayer risk.

Use of private MI and other private credit enhancements to place private capital ahead of taxpayer risk is being implemented on an expanded basis by FHFA in the conservatorship of the GSEs. The 2013 FHFA Scorecard for the GSEs established a goal of transferring credit risk to private markets on $60 billion of GSE-backed mortgages where otherwise taxpayers would be taking the predominant risk of credit loss. This FHFA-directed initiative will further validate the benefits of private capital bearing the predominant risk of loss in front of taxpayers in ways that do not disrupt borrower and lender access to TBA-securitization.

In addition, expanding the role of MI can be done gradually through a known process that works. Reforms that require sudden, "big bang" change to the roles of FHA and the GSEs are risky for borrowers and mortgage market participants alike and present Congress with complex choices and uncertain outcomes. If the change fails to work as expected, the adverse consequences will be felt across the entire economy. Transition approaches that can be sensibly paced, going quickly when private capital is abundant yet reconsidered when not achieving reform, reduce the downside risks from change. The expanded use of private MI through broader risk-sharing meets the objective of sensible pacing, taking on more risk and serving more borrowers as quickly as private capital capacity grows.

In sum, the expanded risk-sharing initiatives at the GSEs represent the most direct and efficient path to increasing private capital and reducing taxpayer risk in the housing finance system. The lessons learned from expanded credit risk-sharing by the GSEs should provide very useful insights to this Subcommittee as it considers ways to reduce government's credit risk-bearing role at both FHA and the GSEs. We encourage Congress to strongly endorse expanded use of risk sharing with private MI by the GSEs under the direction of FHFA, as well as to consider risk-sharing by FHA, as explained below.

Addressing FHA Solvency

Addressing the solvency of FHA is an important element of FHA reform. The FY2012 actuarial report analyzed the economic value of the Mutual Mortgage Insurance ("MMI") Fund and estimated a "baseline scenario" economic value of negative $13.5 billion.[2] The present and estimated future economic values of the MMI Fund place significant reliance on the contribution of new books of business. FHA Commissioner Galante's testimony on February 13th to the House Financial Services Committee emphasized the role of new business by stating, "…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 assumed beneficial impact of new business should be of concern for two reasons:

> First, the actual economic contribution of new business is unknown, subject to future economic conditions that may not prove to be benign. Inherent in writing mortgage insurance is the possibility that significant economic stress will occur resulting in large losses. This concern is validated directly within the FY2012 actuarial review, which provided the economic value of the MMI Fund under economic scenarios less optimistic than the baseline scenario.[3] These less optimistic economic scenarios reported in the study showed lower economic values of the MMI Fund ranging from negative $19.5 billion to as low as negative $65.4 billion.
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> Second, when new business outside of the mission of FHA contributes immediately to the solvency of the MMI Fund, there will be strong incentives working against a return of private capital, which already must overcome the significant advantages of FHA over a private MI industry that must hold real capital, pay federal and state taxes and cover operating expenses. If the policy analysis of taxpayer risk is going to be based totally on assumptions and utilize optimistic economic outlooks rather than stressful scenarios that

[2] U.S. Dept. of Housing and Urban Development, *Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund* (November 2012), Exhibit IV-13 at pg. 47 (forward loans only).
[3] Ibid (forward loans only).

more accurately reflect the inherent risk, the analysis will make privatization of risk unattractive compared to continued nationalization of the risk.

The issue of FHA solvency has been a focus of Congress and the Administration, along with the broader questions of long term housing finance reform. Much is being done to restore the fiscal condition of the MMI Fund and HUD Secretary Donovan and FHA Commissioner Galante should be commended for the actions taken to date to raise premiums and strengthen the financial condition of FHA. We support further steps to address solvency of the FHA MMI Fund on the basis of FHA maintaining a proper, mission-focused business footprint, including:

- Enacting provisions similar to those adopted by the House last Congress in H.R. 4264 "The FHA Emergency Fiscal Solvency Act of 2012";
- Additional authorities HUD has requested to address solvency; and,
- Prudential changes to seller concessions, a policy change HUD has proposed but not implemented.

The Future of FHA and Private MI: A Partnership to Serve the Market

The current structure of the mortgage market often pits private MI and FHA against each other as competitors. The structure results in borrowers who could become home owners by qualifying for private MI to end up in FHA. The FY2012 Actuarial Review reported that over 95% of 2012 FHA loans had LTV's below 97% and 57.5% of all loans had credit scores of 680 or higher.[4] Essent's credit guidelines, and MI industry guidelines generally, extend to LTVs of 97% and credit scores of 680 and above. This data suggests that a meaningful portion of FHA borrowers may qualify for private MI, a conclusion supported by an observed shift in market share for insured loans toward private MI since FHA implemented additional premium increases in April of 2012. In the first quarter of 2012, prior to the FHA premium increases, the private MI share of the insured market was approximately 26%, and rose during the remainder of 2012 to 34.5% in the fourth quarter.[5]

These recent shifts in the market represent progress in returning to a more normal balance of public and private. To sustain the progress, it is important to do more to create a level playing field for private MI. At prior hearings, factors which advantage FHA over private MI were the subject of detailed testimony, including that FHA offers credit terms to all borrowers beyond those allowable in conventional markets (e.g., 6% seller concessions) and that FHA enjoys access to full faith and credit securitization of Ginnie Mae (whereas private MI, being securitized through GSE MBS, does not). Prospective regulations, such as FHA developing its own QM definition, the forthcoming final definition for QRM, and the currently proposed Basel III capital rules for banks, depending on their outcome, could create incentives for lenders and banks to use FHA, even though borrowers could be served at the same or a lower price by private MI. Reforms that can create a more level playing field for private MI will help continue to expand the role of private capital and reduce the need to call on taxpayers to bear the risk of such a large segment of the market.

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[4] Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012, November 5, 2012. See Exhibit IV-5 for LTV distribution and IV-6 for Credit Score (Percentage of Fully Underwritten FHA-Insured Mortgages by Dollar Volume).

[5] "Primary Mortgage Insurance Activity" *Inside Mortgage Finance* (February 28, 2013).

As opposed to competition between FHA and private MI, a better approach is greater partnership between private MI and FHA. In a partnership model, the two types of insurance, private and public, would work together to ensure coverage of the market built on the principle that private should be preferred to public when private can serve borrowers well. In such an approach, the future role of FHA would more naturally expand or contract based on the robustness of the risk tolerance and capacity of private mortgage insurance providers.

The ultimate goal should be a well-functioning market that dynamically adjusts so private risk bearing is as large as possible and public risk bearing is as small as possible, without gaps in the credit access of mortgage-ready borrowers. FHA Commissioner Galante in her testimony to the House Financial Services Committee on February 13th of this year importantly testified that, "By design, FHA's programs are meant to complement, not supplant, private capital." She further stated that FHA should, "...step back when private capital returns or expands to serve previously underserved populations." Essent's partnership approach to private MI and FHA is consistent with the Commissioner's statements. Such an approach can help address concerns with well-intended reforms meant to encourage private capital that could inadvertently have an adverse effect on ready borrowers.

FHA Risk-Sharing with Private MI

If the partnership approach is one Congress considers worthy of exploration, credit risk-sharing between FHA and private MI would be a logical initiative to pursue because credit risk-sharing could be designed to place private capital in a first loss position ahead of taxpayer exposure, placing taxpayers in a more remote risk of loss. There are some broad alternative approaches to risk-sharing we propose for consideration:

1) **Reinsurance** - One approach to risk-sharing would be direct risk-sharing between FHA and private MI, analogous to how the GSEs are moving forward in their expanded risk-sharing initiative. This approach has the benefit of minimizing impacts on primary market participants and has the potential to be implemented more quickly.

2) **Coinsurance** - A second approach to risk-sharing would combine MI and FHA risk-sharing with the objective of deploying the risk management capabilities of MI companies in loan underwriting and claims management. This is analogous to how private MIs work today with the GSEs for new loans with LTVs above 80% that require MI, where borrowers must meet underwriting and eligibility criteria acceptable to both the GSEs and private MI.

The necessary details of the risk-sharing approaches above should be developed and tested through risk-sharing pilots. Much could be learned from pursuit of such pilots, including: (1) which FHA loans are, in fact, privately insurable risks, (2) more robust identification of the reasons FHA loans are not eligible for private coverage, (3) differences between FHA practices from those acceptable in the private market, (4) private versus FHA pricing for risk, and (5) any unintended adverse impacts on borrowers or lenders. This learning could inform more permanent reforms, in conjunction with an assessment of the risk-reducing benefits for taxpayers, appropriately evaluated under the assumption of stressful economic conditions including a material decline in home prices.

To move forward in this direction requires Congress to revise existing statutory authority for FHA to engage in such risk-sharing pilots and to signal a clear desire to see FHA work with private industry to move this forward. Given that FHFA is targeting $30 billion in loans to be included in risk-sharing transactions by each GSE in 2013, consideration should be given to setting a similar target for FHA risk-sharing pilots.

Conclusion

Private investors have demonstrated their interest in investing capital to support the U.S. mortgage market through the private MI industry, enabling the industry to continue to serve low down payment borrowers to achieve homeownership and play a broader risk-bearing role. Accordingly, we support a continued future role for FHA which transitions to a more focused mission of providing access to homeownership to creditworthy borrowers who cannot be adequately served in the conventional market with private MI. In addition, the expanded use of MI by the GSEs in the risk-sharing initiatives announced by FHFA shows that the industry can play an even broader role in bearing credit risk and reducing taxpayer exposure to credit risk.

Reform of the housing finance system should be implemented, including reform of FHA. Changes should be implemented gradually so as not to disrupt a large and vital market. We should find common cause in sound objectives for reform - to reduce taxpayer credit risk, and expand the role of private capital but preserve access to homeownership for creditworthy borrowers. In this regard, we urge the Congress to support:

- Changes aimed at addressing the solvency of FHA within a mission-focused footprint;

- Creating a level playing field between private MI and FHA so that risk does not go needlessly to taxpayers when credit risks are privately insurable. This includes encouraging regulators to establish rules such as QM (for FHA), QRM and Basel III that do not distort the market in favor of taxpayer-backed risk;

- Expanding use of private MI to gradually broaden the role of private capital without adverse impacts on liquidity in the mortgage market. In this context, we specifically encourage consideration of working toward a new, partnership approach between private MI and FHA that moves the market toward that largest role possible for private risk bearing without loss of mortgage access by creditworthy borrowers.

- Testing the potential to expand the role of private capital through risk-sharing pilots by FHA using private MI for privately insurable risk.

Testimony of

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Before the Subcommittee on Housing and Insurance

Of the Committee on Financial Services

United States House of Representatives

"Sustainable Housing Finance: Perspectives on Reforming FHA"

April 10, 2013

Introduction

Chairman Neugebauer, Ranking Member Capuano, and Members of the Committee, thank you for the opportunity to testify on how to reform the Federal Housing Administration (FHA). I am currently an Executive-in-Residence and Tyser Teaching Fellow at the Robert H. Smith School of Business at the University of Maryland. Prior to my role at the University of Maryland I spent more than 20 years at major financial institutions managing or leading risk management functions.

My testimony today focuses on the effectiveness of FHA's structure, its policies, risk assessment and operational capabilities to ensure the long-term financial sustainability of its programs. In addition, I highlight several recommendations that would secure the financial viability of FHA while also clarifying and sustaining its role in the housing finance system. These include placing FHA into a new federal corporation; development of a set of countercyclical policy targets for determining when FHA should scale up during periods of economic stress and when to contract when conditions improve; application of area median income targets to better define its mission; development of more robust risk surveillance capabilities, introduction of risk-based pricing and development of private risk-sharing arrangements consistent with other segments of the housing finance system.

Unquestionably, FHA has served a critical role in our nation's housing market by providing affordable credit to over 40 million first-time homebuyers and other borrowers with limited resources that would otherwise have difficulty obtaining access to credit through more traditional private sector sources. The recent financial crisis and its aftermath underscored the importance of FHA's countercyclical role in providing much needed liquidity and credit to mortgage markets reeling from the withdrawal of private capital during this period. At the same time, FHA in its capacity as public steward of the $1 trillion plus Mutual Mortgage Insurance Fund (MMIF) has responsibility for maintaining the financial integrity of that fund which according to recent actuary analyses has lately experienced considerable stress.

The current state of the MMIF can be directly attributed to a lack of clarity in the scope of its programs, mission conflict between maintaining actuarial soundness of the MMIF and advancing homeownership opportunities to prospective borrowers, a lack of resources to effectively identify, measure and manage risk consistent with an insurance fund of the scale and complexity of the MMIF and a lack of systematic and proactive countercyclical policy mechanisms to guide the agency as economic circumstances change. The question for policymakers is what changes should be made to FHA that provide the agency with the best opportunity to fulfill its critical mission to housing while also protecting the taxpayer? Before proceeding to a set of specific recommendations, it is important to highlight a number of contributing factors to FHA's current financial situation and their implications for markets, borrowers and the MMIF today.

Contributing Factors to FHA's MMIF Fund Challenges

Mission Conflict

In addition to providing access to affordable credit for traditionally low- and moderate-income borrowers typically with lower net worth; FHA is required to maintain the MMIF to a congressionally mandated capital reserve ratio of 2%. Specifically, that means that the economic value of the MMIF net of expected future losses must be at least 2% of the total amount of loans insured by FHA. According to the latest actuary results for 2012, that ratio stands at approximately -1.44 percent. The fact that the MMIF's economic value stands at negative $16.3 billion is evidence that FHA's social mission has overshadowed its financial mission. FHA's experience is in a number of ways similar to that of many private mortgage lenders in the years during the housing boom, when market share objectives came at the expense of significant risk-taking. We now realize that for banking a focus on market share without a healthy appreciation for risk was a recipe for disaster and the lessons learned from this experience are as important for FHA, Fannie Mae and Freddie Mac as they are for the private sector. At the heart of this issue are a host of governance, operational and oversight issues that explain excessive risks borne by FHA over the years.

These twin objectives for FHA at times may be in conflict. For example, in 2010, FHA imposed a minimum borrower credit score (FICO) of 580 as a way of improving the credit quality of new business. Up to that point, the lack of minimal standards on borrower creditworthiness clearly helped FHA expand its reach to borrowers with especially poor credit while significantly raising the risk to the MMIF. The mortgage industry has for years understood that borrowers with such marginal credit history tend to have a likelihood of default on their mortgage that may be as much as 5-8 times higher than that of borrowers with FICO scores of 700 and above, for example. Moreover, FHA can use its pricing of Mortgage Insurance Premiums (MIPs) to affect desired public policy outcomes to serve its perceived social mission. For example, by holding down MIPs below what otherwise would be actuarially sound levels it blunts costs to homeowners while passing them onto the MMIF through higher credit losses that manifest over time. Such policies allow FHA to serve a larger segment of the borrower population, but expose the MMIF to much higher risk. Conversely, setting credit policies too high prevents certain borrower segments from obtaining credit through FHA's various programs. Striking the right balance between FHA's social mission and its duties to maintain the MMIF's financial integrity is complicated and made more difficult by a lack of clarity in defining who its target borrowers are. Such an exercise is about determining what segments of society merit public support as well as about establishing a clear risk appetite that aligns to these goals.

Lack of Defined Risk Appetite

Standard practices today for commercial banks include an articulation of a bank's tolerance for risk-taking. The risk appetite of a bank is like a compass, providing direction to the

rest of the company as to what prudent risks should be taken, or conversely what risky activities to avoid. Risk beyond these stated levels are unacceptable and actions would need to be taken to bring a bank back into compliance. As market and product risks change over time, the risk appetite provides the firm with an effective mechanism for maintaining a consistent level of risk-taking. For FHA, no such risk appetite was set over the years.

Lack of Mission Clarity

Turning to the social policy aspect of FHA programs, FHA's traditional role of serving low- and moderate-income borrowers has expanded into borrower segments that have access to private sources of credit by virtue of loan limits that currently allow higher income borrowers to obtain an FHA mortgage. Reliance on loan limits to determine FHA borrower eligibility rather than on income measures expands federal subsidies to borrower classes that do not need such benefits.

To underscore the policy impact of current FHA loan limits, consider the following example. A borrower in the Los Angeles Metropolitan Statistical Area (MSA) can obtain a loan amount of $729,750. Given prevailing mortgage rates for a fixed-rate 30 year amortizing mortgage and including associated taxes and insurance on an $800,000 property, the monthly mortgage payment would be about $4,175. If the loan met the Consumer Financial Protection Bureau's (CFPB) new Qualified Mortgage rules, the borrower would need to have a monthly income of approximately $9,700, or an annual income of about $116,400. And the income requirements would be even higher if this borrower carried nonmortgage debt obligations. This income level far exceeds the 2012 median family income estimate for LA of $64,800. While FHA continues to serve many low- and moderate-income borrowers today, there clearly is a need to revisit the social and economic rationale for current FHA loan limits as well as consideration for implementing income-based limits.

Operating as an agency within HUD, FHA's financial mission appears to have been relegated to a second order objective over time to the department's stated mission to create strong sustainable communities and quality affordable homes for all. Nowhere in HUD's mission statement does the objective of also ensuring effective financial management of one of the largest insurance funds in the world appear. This apparent imbalance in the strategic focus of HUD only now manifests itself in the form of the MMIF's current financial predicament due largely to the unprecedented crisis in the mortgage market; however, it has taken decades to get to this point over different administrations. In fact, this Administration is to be commended for its quick actions over the last several years to raise premiums, enact tighter credit standards and otherwise bolster risk management. Unfortunately, these initiatives come well after extranormal risk has been taken and have not gone far enough. Moreover, these measures are reactive and not intended to address systemic issues in how FHA operates.

Underinvestment in Risk Management

One manifestation of the heightened focus of FHA on its social mission to the detriment of the MMIF is the historical underinvestment in risk management resources, personnel and technologies essential to managing a fund of such scale as the MMIF. In a way, the focus on maintaining market presence by FHA was not unlike that which affected many mortgage lenders during the housing boom and with similar consequences in terms of credit losses well in excess of expected levels. And although FHA undertook an initiative to transform its risk management processes that is still underway today, in a study by the Government Accountability Office (GAO) conducted in 2011, a number of critical deficiencies in FHA's ability to effectively manage risks were identified. These included staffing shortages in key risk management areas, a lack of adequate systems and capabilities to conduct proper surveillance of emerging risks and threats to the MMIF, delays in obtaining much needed resources and high turnover among key positions. Such findings are the hallmark of an organization not well-equipped to quickly identify, measure and manage risks. These weaknesses further exacerbate adverse selection taking place against FHA, resulting in the agency absorbing excessive risk that it had little ability to identify before it had already been booked.

To put FHA's risk infrastructure into perspective, if the agency were subject to regulatory oversight by one of the bank supervisory agencies it is likely that FHA would be subject to a number of examination findings on its risk management activities. In assessing an institution's risk infrastructure, bank examiners focus on a number of critical areas including the quality of an institution's governance structure for risk management, the adequacy and competence of risk staff, quality of reporting, policies and procedures, data management and analytic capabilities, among others. A widely held perspective among bank regulators is that an institution's risk infrastructure must grow ahead of its lending activity. Without such attention to the quality of the risk management process, an institution or agency in this case would be severely handicapped in an accelerated growth scenario as FHA has experienced in recent years.

In the case of FHA, chronic underinvestment in staffing and technology greatly contributed to the stress placed on the MMIF. The GAO identified critical technology needs in several areas spanning FHA's risk management processes. These included improvements to its automated underwriting system used to evaluate individual loan and borrower quality in an integrated way, the need for FHA to acquire an automated valuation capability to systematically assess collateral value, development of a suite of fraud detection and prevention tools, and an overhaul of the underlying systems capturing FHA data. These are all capabilities that Fannie Mae, Freddie Mac and large sophisticated portfolio lenders have developed as part of their risk management framework and should be expected of FHA as well.

Lacking such capabilities to assess risk at a more granular level during the housing boom severely handicapped FHA as mortgage products underwent a radical and risky transformation from the way they had been underwritten historically. The proliferation of subprime and Alt A

mortgages forced FHA as well as Fannie Mae and Freddie Mac into a type of mortgage market mutual assured destruction scenario where the agencies significantly relaxed credit standards and pricing in an effort to maintain market share against private lenders. Concurrently, underlying changes in risk attributes due to ongoing shifts in borrower behavior toward debt obligations would ultimately lead to much higher credit losses than predicted. Relaxation of underwriting standards facilitated new combinations of risky attributes such as extremely low FICO scores coupled with high LTVs and programs such as the Downpayment Assistance Program for which FHA had little or no historical experience to base pricing adjustments which in turn led the agency to grossly underestimate the level of credit risk in these loans.

In addition, FHA has historically underinvested in robust portfolio surveillance capabilities. Once a loan has been originated, portfolio lenders retaining the asset on balance sheet typically engage in a number of activities to track the loan's default and loss performance against modeled outcomes over time and report material changes in defaults and losses to senior management. Changes in the economy, housing market and individual borrower behavior must be closely monitored. Such early warning mechanisms serve as the basis for effective remediation efforts to avoid default, adjust pricing, credit and collateral policies as well as trigger portfolio-level risk mitigation activities. These capabilities are core to any large portfolio lender's risk function and are staffed with highly skilled risk professionals trained in advanced credit portfolio valuation techniques. Such techniques provide firms with an ability to more accurately assess and price credit risk by allowing combinations of risk attributes to be examined collectively across multiple economic scenarios over time. Without these portfolio tools, FHA finds itself at a distinct disadvantage vis a vis mortgage lenders that optimize the loan's disposition between FHA and other alternatives such as holding the loan in portfolio, or selling the risk to Fannie Mae or Freddie Mac by using sophisticated credit pricing models. Such disadvantages in risk pricing facilitate riskier pools of loans being insured by FHA.

One Size Fits All Pricing

One way FHA inadvertently incurs higher credit risk in the MMIF is by its approach of average pricing credit risk. With the advent of automated underwriting systems and associated enhancements to pricing models, lenders refined their pricing of risk to specific attributes such as loan-to-value ratio (LTV) and FICO score categories, among others. By introducing a tiered pricing structure based on statistically significant differences in credit risk between groups, lenders were able to more accurately price risk, notwithstanding aggressive risk-taking behavior that led to the mortgage crisis. These practices came at the expense of FHA which by utilizing a "one size fits all" flat-rate premium pricing structure allows low risk borrowers to effectively subsidize high risk borrowers. Over time, lower prices charged by government-sponsored enterprises (GSEs) and lenders for loans with low default risk profiles shifted these loans away from FHA and into conventional loan financing, leaving FHA with an increasingly higher risk profile. Thus FHA's reliance on average pricing coupled with limited flexibility to determine premiums based on inherent risk exposure contributed to the MMIF's financial challenges.

Lack of Systematic Countercyclical Policies

In theory one of FHA's virtues is its ability to provide a countercyclical role as economic conditions change. During favorable economic periods, FHA's footprint may be lower as private capital enters the market. However, under periods of economic stress, private capital may evaporate, and FHA's ability to scale up its activities may help limit the extent of a market downturn. This is exactly what happened in the years leading up to the housing crisis and afterward. However, this countercyclical role performed by FHA during these divergent economic periods was less attributed to any systematic policies and triggers designed to proactively respond to changes in market conditions than to a host of issues that put FHA at a competitive disadvantage to other mortgage executions. As the crisis was just beginning, FHA's limited pricing and credit policy response to emerging market events led to a sharp increase in its market share just as lenders and mortgage insurance companies were tightening credit policy and raising delivery fees and other premiums. And more than 5 years after the crisis began FHA's market share remains significantly above historical levels of 10-15 percent due to relatively high loan limits and premiums that crowd out private capital in the mortgage market.

One of the important lessons from the mortgage crisis was that public policies developed during a crisis often time lead to suboptimal outcomes and unintended consequences. A corollary to this lesson is that a proper role for government is to moderate extreme market movements that may come about due to abnormal market behavior. Thus FHA has a third mission; namely to provide a countercyclical balance to the mortgage market. However, effective execution of this important role requires development of a systematic set of policies and triggers in advance of any emerging threats to market stability.

Recommended Reforms to FHA

Ensuring the long-term viability of the MMIF while clarifying FHA's mission can be achieved by implementing a number of reforms aimed at addressing the contributing factors to the current challenges facing FHA. These reforms start with clarifying the role of FHA vis a vis other market participants, restructuring FHA to provide the agency with the flexibility and tools to manage its risks, strengthening its risk management capabilities, and development of new risk-sharing and pricing frameworks to limit risk exposure and accurately price risk.

Provide Mission Clarity

Clarifying FHA's role must begin by taking a comprehensive view of housing finance reform. Complicating effective reform of FHA and the GSEs is the fact that this country has no national housing policy. Rather than implement reforms isolated to each market, policymakers should first consider what the target market is for FHA loans and once determined assess how federal guarantees relate to the rest of the mortgage market. One of the outcomes from the

mortgage crisis was that the market was essentially fragmented but blurred along three artificial lines; FHA, GSE, and private issuers. Over time this market segmentation, coupled with relatively underdeveloped risk and pricing capabilities at FHA, facilitated adverse selection against the agency as lenders optimized the disposition of loans according to their highest value, leaving FHA the clear choice for the riskiest loans.

First and foremost, FHA needs to get back to its historical roots of focusing on providing access to mortgage credit for low- and moderate-income borrowers. The size of the market should ideally be no greater than FHA's historical share of 10-15 percent in a normal market. Achieving this target over time must be done gradually so as to not disrupt the mortgage market. For years median income targets have been used in various affordable housing programs. For example, the Federal Home Loan Banks' Affordable Housing Program (AHP) provides subsidies to borrowers with median incomes at or below 80 percent of area median income. Likewise, affordable housing goals for both GSEs use the same 80% threshold of area median income in defining targets for Fannie Mae and Freddie Mac. FHA should adopt an area median income target to determine program eligibility and phase out the use of area-based loan limits. In conjunction with establishing income-based eligibility requirements, FHA should strengthen its requirements to ensure all eligible borrowers have the best chance of staying in their homes. This comes down to raising the bar on collateral, credit and capacity criteria to repay the mortgage; namely, the 3Cs of underwriting. I would recommend that FHA require a downpayment of at least 5 percent for all lending programs, establish a minimum FICO of 620 and impose a residual income requirement similar to that used by the Veterans Administration.

Restructure FHA

Compared to other large federal, GSE and private insurers FHA has historically struggled with securing sufficient resources to manage its risks. Back at FHA's inception in 1934, no one would likely have imagined that the MMIF would have reached the $1 trillion mark. However, today there is an unsustainable gap between the resources needed to effectively manage the fund and FHA programs and the magnitude of insured risk. In order to attract the right resources to manage its risks, FHA requires greater flexibility and resources to compete with other agencies and private sector employers for risk talent. Today the agency is fortunate that FHA's employees are highly committed to the mission, however, the agency must strengthen its risk infrastructure along many dimensions starting with its human capital.

An optimal structure for an agency the size of FHA would be to establish it within a new federal corporation overseen by a commission comprised of the heads of various federal agencies with housing and mortgage responsibilities and chaired by the HUD Secretary. This entity would bear some resemblance structurally to the Federal Deposit Insurance Corporation. Such a structural arrangement would yield a number of benefits for FHA specifically and housing markets generally.

First, this new corporation would be self-funded off of assessments on loans it insures not unlike what the banking regulatory agencies and GSEs do today. As a result, FHA would finally have the resources needed to manage its risks. Second, the new corporation provides a structure for a post-GSE secondary market that could align pricing and policies in a consistent fashion across markets. Third, the new corporation would mitigate potential conflict between the agency's social and financial missions. By setting the agency up outside of HUD it reduces incentives for future administrations to impose policies on FHA that limit pricing flexibility and/or attract risks beyond target levels. Fourth, the new corporation provides a vehicle for establishing a systematic set of countercyclical policies that can be implemented quickly when required. Fifth, the structure enhances oversight of the operations of a critical part of the housing finance system as well as brings together the various federal agencies with mortgage oversight responsibilities and/or regulated entities with housing-related activities. In a sense the corporation's commission would act as a type of Financial Stability Oversight Council (FSOC) for the housing market which has desperately needed more formal policy integration across federal agencies. Sixth, the new corporation would provide a mechanism for maintaining consistency in key credit policies. Today, rules determining eligibility for qualified mortgage lending are scattered across various federal agencies. This perpetuates policy fragmentation across the mortgage market which leads to policy confusion and inefficient policy implementation. The corporation should have authority to establish, monitor and manage such credit policies under the auspices of the commission. Lastly, FHA's mission to provide access to credit for low- and moderate-income families would not be marginalized under this proposed structure. The HUD Secretary acting as chair of the corporation commission assures that this mission remains central to the work of FHA. At the same time, a commission ensures balance between the often competing social and financial missions of FHA.

Formalize FHA's Countercyclical Role in Markets

Formalizing FHA's countercyclical role should be a priority for any reform of the agency. As described earlier, applying ad hoc changes in premiums, loan limits and other policies during a crisis can introduce confusion to markets and yield outcomes that are not intended. Raising loan limits, for instance during the crisis at first glance provided a mechanism for quickly allowing FHA to support the mortgage market at a critical time, however, it also expanded the eligible borrower population to people that have ready access to credit. Moreover, there currently is no mechanism in place to systematically scale back FHA's market expansion. This policy vacuum essentially postpones any market realignment from occurring that would allow private capital to return in substance.

A set of countercyclical policies and practices should be developed. Taking a cue from the Federal Reserve's targeting of key macroeconomic factors in developing its monetary policy, a set of policy targets for housing and mortgage markets would provide FHA with clear direction on when to expand and contract its business. Such policy targets as local market home price trends, market credit spreads on mortgage securities, and other pertinent housing and mortgage

metrics could provide FHA with direct feedback on the health of these markets. The agency in turn would have the authority with approval of the commission to implement specified policy changes designed to temporarily adjust FHA's programs. Specific triggers with well-defined ranges for each policy target would provide a roadmap for when certain prescribed actions would take place. And the commission could be the final arbiter in any policy action, overriding the policy targets as needed based on their informed judgment at the time. Such a framework would provide needed structure as well as policy flexibility and responsiveness as market conditions change.

Allow FHA to Engage in Risk-Sharing Arrangements

Unlike many other holders of credit risk, FHA has no formal mechanism to transfer credit risk to the capital markets. As a result, FHA winds up holding 100 percent of the credit risk even though it may be economically advantageous to engage in risk-sharing arrangements with various market participants. For instance, both GSEs are required to have suitable credit enhancement for loans above 80% LTV. Private mortgage insurers provide first-loss coverage depending on the LTV between 25-35 percent. Such arrangements allow the GSEs to distribute risk across other counterparties rather than concentrate risk on their balance sheet.

Credit enhancements are also effective for reshaping the risk profile of the existing insured book. For example, large portfolio lenders and the GSEs from time to time will enter into reinsurance contracts with approved counterparties to sell portions of credit risk in their loan portfolios. Best practice portfolio risk management exercises are not static but rather make regular adjustments to the risk profile of the insured book as market conditions or loan performance is anticipated to change. FHA should have the flexibility to enter into such arrangements.

Currently, the FHFA has embarked on a credit enhancement pilot with both GSEs to contract their balance sheets and this initiative will also provide insights into what credit structures appear operationally and economically most viable. As a way of both reducing the risk of the MMIF and initiating experience with such structures, FHA should begin to selectively test a variety of credit enhancements. However, in order to engage sophisticated investors in credit risk transfer structures, the agency will need to build its analytical, data and credit structuring capabilities well beyond what is in place today.

Strengthen FHA Pricing

FHA also needs to enhance its MIP pricing capabilities. These activities are dependent on robust pricing models and accurate data that can provide a granular assessment of credit risk. With such capabilities, FHA should begin to deploy risk-based pricing matrices that differentiate risk across various categories of risk attribute such as LTV, FICO and product type. Likewise, the agency needs to be able to adjust pricing that reflects important shifts in underlying credit risks when market conditions and risk profile changes.

Establish FHA's Risk Appetite

In clarifying FHA's social mandate, the agency should define that role conditional on a prescribed risk appetite. The risk appetite framework should articulate that the agency seeks to insure loans for creditworthy low- and moderate-income borrowers that have personally put up equity for the home. The risk appetite should also outline a target expected loss for the MMIF over time as well as a target maximum loss level with some level of confidence. Such metrics are commonly used by large financial guarantors in managing their risk and given the size of the MMIF should be introduced formally into FHA business model.

Establish a Housing Market Utility

The relationship between FHA and the Government National Mortgage Association (GNMA) is a model that could work well in a post-GSE environment. Again, with a broad view of the secondary market at-large, GNMA could become an effective housing finance market utility that serves several key operational functions. First, its securitization platform could become universal to all issuers over time with some modifications, thereby providing consistency and transparency to investors. The FHFA has undertaken an initiative to develop a new securitization platform for the GSEs and such efforts ought to be coordinated with GNMA closely. Second, the evolution of GNMA to a market utility should include its role in developing effective pooling and servicing agreements (PSAs) for securities other than GNMA. Third, the utility should become the repository for the National Mortgage Database currently under development by the FHFA and CFPB. Such a database would provide regulators, FHA and other key stakeholders with the information needed to make adjustments to countercyclical policies, credit and collateral policy, and pricing of federal guarantees, among other far-reaching benefits for the industry.

Concluding Remarks

Without question FHA is an essential part of the housing finance system. While maligned for the current financial challenges of the MMIF, it is important to keep in mind that FHA has served this country well for nearly 80 years. However, like many institutions, FHA has not kept pace with important structural changes in its market. The advent of securitization and other sophisticated capital markets risk transfer mechanisms have left FHA at a competitive disadvantage vis a vis other market participants. The lack of a clearly defined mission for FHA along with potential conflict between its social and financial missions are major contributing factors to the current state of the MMIF. The agency requires a number of major reforms in order to put it on a secure financial footing that will ensure its important legacy for borrowers for the next 80 years.

Statement of
David H. Stevens
President & CEO of the Mortgage Bankers Association

Subcommittee on Housing and Insurance
Committee on Financial Services
U.S. House of Representatives

"Sustainable Housing Finance:
Perspectives on Reforming FHA"

April 10, 2013

Chairman Neugebauer, Ranking Member Capuano, and members of the subcommittee, thank you for the opportunity to testify today on behalf of the Mortgage Bankers Association (MBA). My name is David H. Stevens, and I am the President and CEO of MBA. From 2009 to 2011, I served as Assistant Secretary for Housing and FHA Commissioner at the U.S. Department of Housing and Urban Development (HUD). I have over 30 years experience in real estate finance. On a personal note, FHA allowed me to achieve the American dream of homeownership; I bought my first home in the early 1980's with an FHA-insured loan.

FHA made headlines at the end of 2012 following the revelation that its Mutual Mortgage Insurance (MMI) Fund, which holds the accounts for the single-family programs, had a negative capital ratio. Conversely, accounts for FHA's multifamily rental and healthcare programs, which are supported by HUD's General and Special Risk Insurance (GI/SRI) Fund, are fiscally sound. The Actuarial Review of the FHA MMI Fund Forward Loans for Fiscal Year (FY) 2012, released by HUD on November 16, 2012, confirmed that FHA, like most participants in the mortgage market, is still dealing with fallout from the recent housing crisis.

MBA firmly believes that FHA has a vital role in the United States' housing finance system and its mission of serving first-time homebuyers and underserved populations and playing a countercyclical role should continue. Since its inception in 1934, FHA has enabled more than 40 million families to become homeowners.[1] In FY 2012, 77 percent of FHA purchase endorsements were to first-time homebuyers and 33 percent were to minority homebuyers. According to Home Mortgage Disclosure Act (HMDA) data, in 2011, 56 percent of African American homebuyers, and almost 59 percent of Hispanic homebuyers financed their purchases with FHA loans.[2] In 2012, applications for government refinance loans (primarily FHA) were almost 15 percent of all refinance applications, while applications for government loans to purchase a home were 37 percent of all purchase applications.[3] Thus, recent data confirm that FHA continues to play an especially critical role in providing homeownership opportunities.

Given the negative financial position for FHA's single-family program, a reexamination of U.S. housing policy is warranted. The policy decisions made today will help determine FHA's financial solvency, and whether it can continue to fulfill its traditional mission without taxpayer support. Congress, the Obama administration, and other stakeholders will need to consider requisite trade-offs that seek to balance FHA's financial stability against the maintenance of a program that facilitates homeownership for slightly higher risk consumers who might not otherwise be able to qualify for a loan. It is within this context that MBA provides this statement evaluating various policy options that FHA could undertake to ensure the long-term viability of its single-family and multifamily programs.

FHA and its Role in the Housing Market

FHA has played an important countercyclical role in the mortgage markets, both historically and in the most recent housing downturn. As private market credit risk appetites grew during the pre-crisis years, FHA began to lose market share. FHA's market share significantly declined during the early 2000s, a period when the private market was experiencing significant growth

[1] U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 11. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf.
[2] MBA analysis of 2011 HMDA data.
[3] Data compiled from MBA Weekly Applications Surveys.

due to alternative mortgage products and a rise in demand for private label mortgage-backed securities.

Many of FHA's traditional borrowers – low-wealth families with minimal funds for a downpayment – left FHA during the housing boom for subprime and other loans that provided lower initial monthly payments and more lenient credit requirements such as limited or no documentation. As the housing markets heated up, FHA's fully documented underwriting was perceived as overly onerous and bureaucratic. From 2003 until 2007, FHA's share of the mortgage market hovered between two and seven percent.[4] Its flagship 30-year fixed-rate mortgage was shunned by many borrowers looking for lower initial mortgage payments. In addition to FHA's more stringent underwriting standards, there was a general belief by many market participants, lenders and borrowers alike, that FHA-insured loans were too time-consuming, expensive, and complicated compared to conventional or subprime loans. As a result, FHA was not the first choice for many real estate borrowers, brokers and lenders.

During this explosion of subprime lending, FHA was further weighed down by seller-funded downpayment assistance programs, which proved to be extremely costly to the MMI Fund. These programs often resulted in inflated property values and real loan-to-values (LTVs) in excess of 100 percent. These seller-funded downpayment assistance program loans have performed two to three times worse than typical FHA-insured loans, and still represent an expected drain on the Fund of about $15 billion in the years ahead.[5] The Actuary estimates that if seller-funded downpayment loans were not in FHA's portfolio, the net economic value of the MMI Fund would be positive $1.77 billion.[6]

As the housing market began to tumble in 2007, the private label market contracted precipitously and lenders began to shift as much production as possible to FHA, Fannie Mae, and Freddie Mac. The Economic Stimulus Act of 2008 increased both conventional and FHA loan limits throughout the country, especially in high-cost areas. Approximately 75 of the highest cost counties in the nation saw the FHA loan limits more than double from $362,790 to $729,750. Another 500 counties had new loan limits set between $280,000 and $729,750. The remaining 2,500 counties had new loan limits of $280,000, up from $200,000. The once dormant FHA experienced high demand from coast to coast.[7] At the height of the housing crisis in 2009, government loans accounted for over 40 percent of the purchase market compared to 34 percent today.[8] Most of these loans were FHA-insured. Importantly, unlike the private sector and the government sponsored enterprises (GSEs), FHA moved slowly to tighten its credit standards, even though the agency was partly shielded by lenders making their own decisions to put credit overlays on FHA-insured loans to mitigate risk. Even with these actions, in performing this countercyclical role, FHA's post-crisis books-of-business - 2008 and 2009 vintage loans- continue to show very significant losses, as reflected in the FY 2012 Actuarial Review.

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[4] U.S. Dept. of Housing and Urban Development, FHA Single Family Activity in the Home-Purchase Market Through June 2012. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=fhamkt0612.pdf.

[5] U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 7. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf.

[6] *Ibid* at p. 25.

[7] Mortgage Bankers Association, The Future of the Federal Housing Administration and the Government National Mortgage Association (September 2010) at p. 26. Can be accessed at: http://www.mortgagebankers.org/files/ResourceCenter/FHA/TheFutureofFHAandGinnieMae.pdf.

[8] Data compiled from MBA Weekly Applications Surveys.

FY 2012 Actuarial Review

The Actuarial Review provides an annual assessment of the fiscal health of the FHA and its financial outlook at a particular point in time. The FY 2012 Review showed that the capital ratio of the MMI Fund had fallen to negative 1.44 percent, well below its statutory 2 percent requirement. In the FY 2011 Review, the ratio was 0.24 percent, and the ratio for the prior two years had been below the statutory 2 percent minimum as well. The news that the capital ratio had turned negative prompted immediate concerns that FHA might require a draw from the U.S. Treasury (Treasury) - the first in the agency's history - and called into sharp focus whether FHA's policies need to be adjusted.

Highlights of the Actuarial Review include:

- The negative 1.44 percent ratio represents a negative economic value of $16.3 billion. This is the first time the Fund has been negative since the early 1990s.
- The *economic value* indicates the amount of resources the fund has over and above the reserve held for expected losses over the full life of the mortgage portfolio.
- The Actuarial Review cites several important reasons for the decline in the capital reserve ratio, including:
    - A less optimistic House Price Appreciation (HPA) forecast since last year ($10.5 billion reduction).
    - Lower historic and projected path for interest rates ($8 billion reduction). More borrowers are projected to pay off their mortgages, which reduces future revenues to the current portfolio.
    - Refinements to the forecasting model. Following recommendations by the GAO, HUD's Inspector General, and others, the actuary changed the way it calculates losses on defaulted loans. This change in methodology resulted in an estimated $13 billion ($10 billion on the forward mortgage portfolio; $3 billion on reverse mortgage loans) in reduced economic value compared to last year's projections. Previous models did not adequately model the differential loss severities of pre-foreclosure sales (short sales) versus conveyances (REO sales). In particular, last year's model did not apply large enough loss severities for very high LTV loans. This year's Review takes a more comprehensive approach towards the modeling of previously modified loans.
- The total *capital resources* of the Fund at the end of FY 2012 were estimated to be $30.4 billion.
- The Actuarial Review finds that there is a five percent chance over the next few years that *capital resources* will go negative.
- Focusing on the forward portfolio, as of the end of FY 2012, the Fund is projected to have an estimated economic value of negative $13.48 billion, an unamortized Insurance-in-Force (IIF) of $1,126.27 billion and amortized IIF of $1,053.33 billion.
- The economic value of the 2007-2009 books of business is negative seven percent while the economic value of the 2010-2012 books of business is positive three percent.
- The FY 2012 book of business is projected to contribute an estimated $11.92 billion in present value to the economic value of the Fund.

- The economic value is projected to increase over the next seven years to reach $54.25 billion by the end of FY 2019. However, this estimate is subject to assumptions regarding the volume and composition of future books of business.
- HUD also reports that the Home Equity Conversion Mortgage (HECM), FHA's reverse mortgage program, portfolio has a negative economic value, negative 3.5 percent. Adding the economic value of the forward mortgage and HECM program produces a total economic value of negative $16.3 billion.

Importantly, these findings do not mean that FHA has insufficient cash to pay insurance claims, a current operating deficit, or will need to immediately draw funds from Treasury. Indeed, the Actuarial Review itself does not determine if FHA needs a draw from Treasury; that need is determined by the economic assumptions used in the President's FY 2014 budget proposal. The final determination on a potential draw will be made in September 2013.

Given that the country just went through a severe recession from which it is still recovering, it is not surprising that FHA is experiencing significant losses on loans made during the crisis, as well as losses on the large volume of new business. High unemployment, steep home price declines and the seller-funded downpayment assistance program loans weighed heavily on the MMI Fund. The Actuarial Review estimates that the forward loan portfolio in MMI Fund may not be positive until 2014, and will reach the statutory two percent threshold some time in FY 2017; the HECM portfolio is not projected to be positive within the timeframe of the Actuarial Review.[9]

MBA has reviewed the audits of the MMI Fund. These audits used a wealth of data and sophisticated modeling techniques. MBA believes that minor specification changes in the default model, or subtle differences in the treatment of the data, would not have yielded significantly different results. Uncertainty regarding the economy is a more important factor.

With regard to economic uncertainty, MBA wishes to underscore that the soundness of FHA's financial position is intricately tied to whether the assumptions and predictions that were used as the basis for the Actuarial Review hold true. While the industry is cautiously optimistic about FHA's recent programmatic changes, MBA recognizes the severity of the losses stemming from the 2007-2009 books of business are so great, and the uncertainty in forecasting economic trends is so high, that the possibility of a further decline in the capital ratio must be acknowledged.

Moreover, assumptions regarding certain key variables, including the future paths of home prices and interest rates, can significantly sway the estimate of Fund value in either direction.

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

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[9] U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 46. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf.

although, clearly the recent crisis has taken a severe toll on the FHA's financial stability which may require additional programmatic changes.

National Delinquency Survey Recap from Fourth Quarter 2012

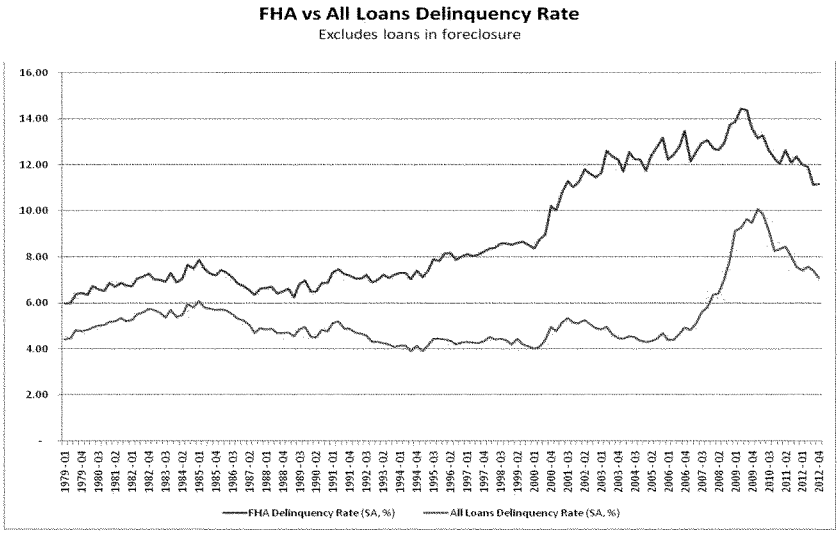
On February 21, 2013, MBA released its fourth quarter 2012 National Delinquency Survey (NDS) results. There were large improvements in mortgage performance nationally and in almost every state. The 30-day delinquency rate decreased 21 basis points to its lowest level since mid-2007. With fewer new delinquencies, the foreclosure start rate and foreclosure inventory rates continued to fall and are at their lowest levels since 2007 and 2008, respectively. Overall, we believe that these improvements in market conditions bode well for FHA as it works to improve its financial situation.

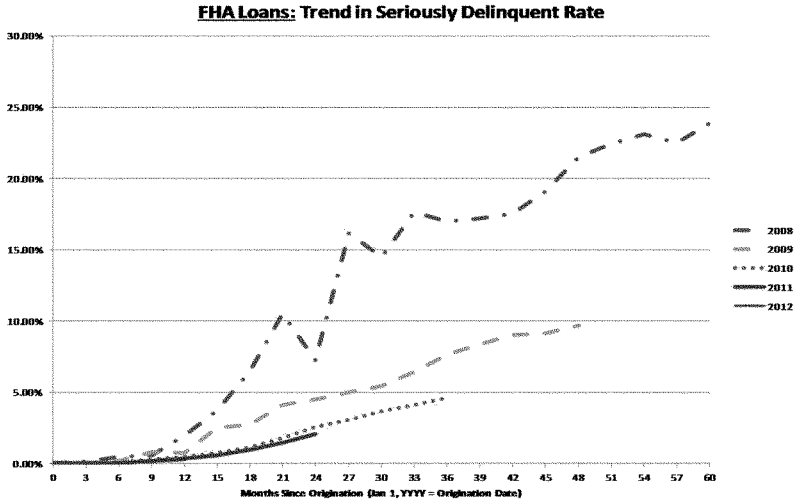
The foreclosure starts rate decreased by the largest amount ever in the MBA survey and now stands at half of its peak in 2009. Similarly, the 33 basis point drop in the foreclosure inventory rate is also the largest in the history of the survey. One cautionary note is that the 90-day+ delinquency rate increased by eight basis points, reversing a fairly steady pattern of decline and the largest increase in this rate in three years. While we normally see an increase in this rate in individual states when they change their foreclosure laws, 38 states had increases in the percentage of loans three payments or more past due, indicating that we could see a modest increase in foreclosure starts in subsequent quarters.

The two biggest factors impacting the number of loans in the foreclosure process still are the magnitude of the problem in Florida and the judicial foreclosure systems in some states. Twelve percent of the mortgages in Florida are in the process of foreclosure, down from a peak of 14.5 percent last year but still an extraordinarily high rate that is impacting the national rate. Florida accounts for almost 24 percent of all loans in foreclosure in the nation, but only 7.4 percent of loans serviced. In addition, while the percentages of loans in foreclosure dropped in almost all states, the average rate for judicial states was 6.2 percent – triple the average rate of 2.1 percent for non-judicial states. In those cases, the ultimate reduction in the number of loans in foreclosure will have less to do with the recovery of the economy and the housing market than with the return to reasonable foreclosure timelines.

The performance of FHA loans was mixed. While the foreclosure starts and foreclosure inventory percentages both fell, the delinquency percentages generally remained flat or increased slightly, particularly the percentage of loans 90 days or more past due. The other loan types generally saw declines in delinquency rates in the fourth quarter. However, 44 percent of FHA loans that are seriously delinquent were made in the years 2008 and 2009, while loans made in those years represent a smaller share of FHA's overall book of business.

After large third quarter increases in the foreclosure starts and inventory rates for FHA loans due to actions by some large servicers to re-start foreclosure processes that had been temporarily halted, these rates fell in the fourth quarter. The percent of loans in foreclosure for FHA loans decreased to 3.85 percent, and FHA foreclosure starts decreased to 0.86 percent. The percent of FHA loans in foreclosure was almost 40 basis points lower than the record high of Q2 2012, but remained well above historical averages.


FHA vs All Loans Delinquency Rate
Excludes loans in foreclosure
16.00
14.00
12.00
10.00
8.00
6.00
4.00
2.00
-
FHA Delinquency Rate (SA, %)
All Loans Delinquency Rate (SA, %)


FHA Loans: Trend in Seriously Delinquent Rate
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
0 3 6 9 12 15 18 21 24 27 30 33 36 39 42 45 48 51 54 57 60
Months Since Origination (Jan 1, YYYY = Origination Date)
2008
2009
2010
2011
2012

Recent FHA Policy Changes

FHA has made a series of single-family risk management and lender oversight and enforcement changes over the last two years, such as raising the annual mortgage insurance premium several times, increasing downpayment requirements from 3.5 percent to 10 percent for borrowers with credit scores below 580, eliminating FHA's approval of loan correspondents, raising lender net worth requirements in all programs, re-examining HECM policies, and establishing the Office of Risk Management. By making these changes, FHA has taken substantive steps over a short period of time to protect the Fund. The credit profile and performance of the FY 2010 to 2012 portfolios are testaments to these changes: the average FHA credit score for FY 2011 was 696[10] and the delinquency rate was 2.07 percent in the fourth quarter of 2012.[11] Significant performance improvement in the Fund is especially notable in the 2010, 2011, and 2012 books of business.

More recently, in response to the FY 2012 Actuarial Review, FHA announced a series of program changes aimed at increasing revenue, reducing credit risk, and improving the management of the existing portfolio. MBA believes that these recent changes are fiscally prudent and warranted given the financial realities described in the Actuarial Review.
In late January 2013, FHA announced the following administrative changes directly aimed at either increasing revenue or reducing credit risk:

1. Increase in the annual mortgage insurance premium (MIP) of 10 basis points for all forward loans, except streamline refinances effective for case number assigned on or after April 1, 2013.
2. Change in the MIP cancellation policy to require that most loans charge the MIP for the life of the loan, or 11 years, effective June 3, 2013 for loans with case number assigned on or after that date.
3. Change in credit policy to require that borrowers with credit scores under 620 must be manually underwritten, effective April1, 2013.
4. Consolidation of the HECM Fixed Rate Standard Program and HECM Saver Program, to allow borrowers to have the predictability of a fixed-rate, but with a lower upfront fee, effective April 1, 2013.

In addition, MBA supports FHA's recent proposal to lower the maximum LTV on FHA-insured loans above $625,500 from 96.5 percent to 95 percent, which effectively raises the minimum downpayment on these loans from 3.5 percent to 5 percent.

Looking forward, there is shared concern among industry, consumer groups, policymakers, and Congress that additional steps may be needed to ensure that FHA is financially secure for the long term. At the same time, some are concerned that recent decisions and potential upcoming programmatic changes may be too costly in terms of homeownership opportunities and potentially cutting off credit to vital sections of the market. Both sentiments are valid and deserve serious, thoughtful, and balanced consideration.

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[10] U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 18. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf.
[11] *See* Chart on page 7.

Policy Considerations

From MBA's perspective, further programmatic changes at FHA must balance three priorities:

1. Restoring financial solvency to the MMI Fund;
2. Preserving FHA's housing mission; and
3. Maintaining FHA's countercyclical role.

Congress and this Administration face the challenge of striking a balance among these three goals. Moreover, policymakers must decide whether FHA requires marginal changes to its current program to meet these goals or whether substantial changes to the program are required.

Any decision regarding substantial, systemic changes, however cannot be done in a vacuum. Changes that shift the role of FHA within the housing finance system must be done with consideration of the current debate of the future of the GSEs. Adjustments in how the FHA, Ginnie Mae, Fannie Mae or Freddie Mac function within the system could greatly impact the operations, policies, or market share of the others. Prudent action is necessary in order to limit unintended consequences that could be detrimental to the entire U.S. economy.

MBA is currently working with a member advisory group that will make policy recommendations for FHA. MBA will release those recommendations as a resource for this subcommittee and other policymakers. The items below reflect some of the considerations that the group is examining.

FHA and Private Capital: Risk-Sharing and Guarantee Reduction

One of the most fundamental questions that has been asked since the revelation of FHA's negative capital ratio is whether the private sector should have a role in sharing risk with the FHA and if so what should that role be. Some policymakers and industry participants, such as private mortgage insurers, have suggested that the FHA should incorporate risk-sharing options in its business model as a way of offsetting some of the agency's current risk, reducing the size of the government's footprint, and thus mitigating the threat to the MMI Fund and better protecting taxpayers. MBA agrees that the option of third-party risk-sharing should be explored.

Congress and FHA should consider scenarios where first-loss private capital is ahead of the FHA government guarantee. The risk-sharing could be at the individual loan level, such as by including private mortgage insurance, or instead, at the level of the mortgage-backed security (MBS). MBA notes that any risk-sharing at the MBS level would probably have to be conducted in conjunction with Ginnie Mae. Proponents suggest that risk-sharing not only protects the taxpayer, but also increases the quality of underwriting either by the private mortgage insurers or by lenders who will have an increased incentive to make sure that the borrower can afford the loan. On the other hand, others are concerned that private insurers would be able to adversely select FHA, providing insurance only on lower risk loans, while leaving the government to fully insure higher risk loans.

Beyond the concerns about adverse selection, the specific details of any risk-sharing proposal would be critical and it would be imperative that any structure not advantage lenders with certain business models over other constructs. For example, MBA would be wary of any risk-sharing

proposal that was not viable economically for diverse lender business models, particularly community banks and independent mortgage bankers.

Another option for mitigating taxpayer risk would be to reduce FHA's guarantee to less than 100 percent. Since the November 2012 release of the Actuarial Review, some industry stakeholders have suggested that the FHA should lower the guarantee on FHA-insured loans from 100 percent to something similar to the U.S. Department of Veterans Affairs (VA) home loan guarantee which ranges from 25 percent to 50 percent. Proponents contend that such a change would be beneficial because it would reduce FHA's potential liability on the loans it insures, thus protecting the taxpayer. Moreover, similar to risk-sharing, a reduction in FHA's guarantee would incentivize lenders to improve origination quality as private capital exposed to credit risk would demand more careful lending thereby reducing exposure to losses resulting from borrower default.

MBA has begun to evaluate the significant implications of such a policy. Among other consequences, a change such as this would impact Ginnie Mae pricing, FHA mortgage insurance premiums, the ability of independent mortgage bankers and other smaller lenders to retain risk, and affect VA loan pricing.

For example, putting risk back to lenders/servicers would necessitate that Ginnie Mae, which now relies upon a full credit guarantee from FHA, to spend additional resources (and likely raise the Ginnie Mae guarantee fee) to monitor and manage this new counterparty risk. It is possible that reducing the 100 percent guarantee would simply move risk from one government entity to another. It is unclear whether Ginnie Mae currently has the resources to manage additional counterparty risk. Additionally, smaller mortgage lenders are accustomed to managing representation and warrant risk, but are not structured to take on large amounts of credit risk, potentially causing them to restrict credit or leave this business. Conversely, larger lenders with a national reach and large balance sheets might be able and willing to taking on additional risk if it meant a larger market share. This could lead to further consolidation in the mortgage banking industry and fewer credit options for consumers. Moreover, because of the 100 percent guarantee, FHA-insured loans held in lenders' portfolios receive a zero percent risk weight. Reducing the FHA guarantee could lead to different accounting and bank capital treatment of holding or servicing FHA-insured loans. The issue is complex, as the change in guarantee would impact lenders differently based on their business model, thus possibly impacting the cost and availability of credit to American homebuyers.

Risk Management Resources

MBA has long advocated for FHA and Ginnie Mae receiving the necessary resources to hire new staff with current mortgage market skills to appropriately manage the single-family and multifamily portfolios. MBA supports the recent efforts that FHA has taken to improve its risk management and protect the safety and soundness of the agency, but these efforts cannot be sustained without ample, highly-qualified, professional staff and modern, state-of-the art technology. FHA and Ginnie Mae should be given the ability to recruit and pay staff at a higher federal pay scale, on par with other "professional-grade" cabinet, regulatory, and independent agencies that require specialized expertise, such as the Federal Deposit Insurance Corporation (FDIC) or the U.S. Securities and Exchange Commission (SEC). Although FHA's market share is likely to decrease in the future as more private capital returns to the mortgage market, we recognize that FHA will still need the resources to manage endorsements for the lifespan of these loans and we support giving FHA the funds and flexibility to do so. Moreover, MBA

recommends both agencies also have the ability to more broadly utilize retention allowances, recruitment bonuses, and superior qualifications appointments.

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

Risk-Based Underwriting

In underwriting borrowers, individual risk factors can sometimes be mitigated by compensating factors. FHA's traditional underwriting philosophy takes this approach. Attempting to further improve the credit quality of the portfolio through excessive risk tightening could delay or prevent homeownership for responsible borrowers and is counter to FHA's mission. Congress and the administration need to recognize that while the losses in the 2008 and 2009 books can be reduced and managed through better default management execution at FHA, changing credit standards on future books will not reduce embedded losses, and may actually harm the housing market recovery.

Risk-based underwriting, or specifying particular underwriting criteria within certain credit boundaries, could be structured in various ways to reduce FHA's credit risk. As indicated below, the social consequences could be significant if FHA employs overly stringent credit controls. Thus, finding the right balance is critical.

Downpayment Requirement

Increasing FHA's minimum downpayment requirement would immediately improve FHA's risk profile on new business, but possibly at an unacceptable social cost.

An increase of the minimum downpayment from 3.5 percent to 5 percent for FHA-insured loans would reduce expected losses to the MMI Fund through lower default rates and lower loss severity in the event of default. This step would increase the economic value of future books of business, but obviously would do nothing to reduce losses already on the books. Moreover, the performance of the 2010 – 2012 books clearly indicates that higher downpayments are not a necessary condition for a strong performing book. It should be noted that the enterprises GSEs, Fannie Mae and Freddie Mac, price differently based on LTVs. For example, Fannie Mae charges an additional loan level price adjustment of 50 basis points for loans with LTVs between 95 and 97 percent.

FHA has made similar policy changes that increase minimum downpayments for certain borrowers. A borrower with a credit score below 580 is required to have a 10 percent

downpayment. Additionally, HUD has proposed raising the minimum downpayment for borrowers with loans above $625,500 to five percent.

FHA could continue this trend by designing a tiered downpayment structure based on credit scores where borrowers with the greatest risk of defaulting would be required to pay higher downpayments than borrowers with better credit scores. A borrower's credit score is a predictor of probability of default. FHA could consider a structure similar to the following: 3.5 percent minimum downpayment for borrowers with credit scores 620 and greater; 10 percent minimum downpayment for borrowers with credit scores between 580 and 620; 15 percent downpayment for borrowers with credit scores less than 580.

Changing the singular downpayment structure in a way that is contrary to the average pricing/cross-subsidization model that currently exists, however, could makes mortgages less affordable for borrowers on the margins. Furthermore, it is not clear whether a borrower who could accumulate a 10 percent downpayment would still choose a FHA loan, which could lead to the loss of some higher quality borrowers.

In short, the social consequences of increasing the minimum downpayment requirement could be dramatic. An increase would unnecessarily delay home purchase for many Americans who might be successful homeowners, with the greatest impact falling on the underserved. In particular, a tiered downpayment structure would place a greater financial burden on borrowers who may have the least amount of savings.

Credit Score Floor

In response to the FY 2012 Actuarial Review, FHA is requiring borrowers with credit scores below 620 to have a maximum debt-to-income ratio no greater than 43 percent in order for their loan applications to be approved through FHA's TOTAL Scorecard, an automated system used by FHA-approved lenders to score the quality of an FHA loan application.[12] Borrowers with credit scores and DTI ratios that do not meet these requirements may still obtain an FHA-insured loan, but their loan application must be manually underwritten by the lender to ensure adequate compensating factors.

Raising the minimum credit score to 620 for all borrowers would reflect the current market standard of private lenders, making FHA less subject to adverse selection based on its credit policy. As the most recent Actuarial Review indicates, there is a strong correlation between the credit score and loan performance. As the average FHA credit score has risen, performance of the corresponding books of business has greatly improved. Borrowers with extremely weak credit may be better served by credit counseling and a slower path to homeownership, rather than a costlier loan today.

A downside risk is that raising the minimum credit score to 620 could reduce affordable credit options for many borrowers, some of whom may have qualified for a loan had it not been for a one-time life event, such as job loss or medical expenses. FHA has been one of the few fully-underwritten and documented lending options for borrowers with impaired credit. Increasing

[12] Letter from Acting Assistant Secretary for Housing, FHA Commissioner Carol Galante to Sen. Robert Corker, December 18, 2012. Can be accessed at: http://www.corker.senate.gov/public/_cache/files/940b16a2-a401-418f-b409-5dca6e176c42/12-18-12_Letter%20from_Carol_Galante.pdf.

FHA eligibility standards may provide fertile ground for the growth of a new subprime market and/or predatory lending.

Reserve and Debt-to-Income Requirements

Similar to the downpayment option, structuring reserves and DTI requirements on a tiered basis could promote even stronger performance than that seen in recent books. Reserves and DTI requirements would better enable higher risk borrowers to absorb major expenses, such as replacing a heating system or paying for a car repair without risking delinquency. These changes would positively impact FHA's default rate and should reduce future claims. This would be another means of ensuring borrowers are truly prepared for the cost of homeownership.

Conversely, these changes would also delay homebuying for borrowers who would potentially need to accumulate additional cash for a downpayment.

High-Cost Loan Limits

In 2011, Congress extended the high-cost loan limits first enacted in the Economic Stimulus Act of 2008, thereby maintaining the FHA high-cost loan limit of $729,750 until December 31, 2013. Importantly, this loan limit was only extended for FHA-insured loans; the GSE loan limit was lowered to $625,500. According to MBA data, less than one percent of FHA-insured loans are between $625,500 and $729,750. FHA lending above $625,500 is most prevalent in the following areas: Washington D.C. (12.9 percent); California (3.4 percent); Virginia (3.2 percent); and New York (3.1 percent).[13]

There is evidence that the demand for large loans is growing and that these borrowers will be adequately served by the private sector. According to MBA's Weekly Application Survey Data, there was a 22 percent increase in the number of loans between $625,000 and $729,000 from 2011 and 2012. As the demand for this market grows, the private sector will readily expand its offerings to qualified borrowers.

Allowing the current high-cost area loan limits to expire in 2013, and reducing them to the GSE loan limits, would help sharpen FHA's focus on serving low-to-moderate income and first-time homebuyers. The expiration would not greatly affect national FHA lending and would expand the opportunity for private lenders to serve higher income borrowers.

On the other hand, according to FHA data, larger loans tend to perform better compared with smaller loans in the same geographical area. Also, borrowers are already charged an additional 25 basis points for these loans.[14] Thus, these high-cost loans actually improve the performance of the MMI Fund and provide additional revenue. Given that loans above $625,000 comprise a small percentage of FHA's portfolio, but have a significant number of positive attributes, policymakers might consider extending the limits until the MMI Fund is financially stable.

While it would be rational to lower the high-cost FHA limits to focus the program on lower-income and lower-wealth borrowers, the question is when to make this change. It is also

[13] Data compiled from MBA Weekly Applications Surveys.
[14] Integrated Financial Engineering, Inc., Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012 (November 2012) at p. 48. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=ar2012_forward_loans.pdf.

important to recognize that making this change is unlikely to contribute positively to the financial health of the Fund, but would primarily serve to focus FHA on serving these borrowers.

Lender Enforcement

In recent years, FHA has greatly increased its enforcement of agency-approved lenders. FHA has:

- Enhanced monitoring of lender performance and compliance with FHA guidelines and standards (Effective January 21, 2010).[15]
- Expanded the Credit Watch Termination Initiative to include evaluation of lender underwriting performance in addition to origination performance (Effective January 21, 2010).[16]
- Implemented its statutory authority through regulation of section 256 of the National Housing Act to enforce indemnification provisions for lender's using delegated insuring process (Effective February 24, 2012).[17]

Post crisis, lenders have typically been more conservative in their origination standards than FHA would permit. In fact, this is one of the reasons that FHA's financial position, while troubling, is not as dire as that of the GSEs: lenders acted to control the risk profile of FHA lending because even though the loans were guaranteed, enforcement actions against lenders in the event of default are extremely costly.

According to HUD, since early 2009, heightened enforcement of its requirements for FHA-approved lenders has resulted in over 1,600 lenders being withdrawn from FHA's program as a result of violations of FHA approval, origination, or servicing requirements and the imposition of more than $13.8 million in civil money penalties and administrative payments for FHA-approved lenders.[18]

Additionally, the U.S. Department of Justice (DOJ) has recently begun filing court actions against lenders under the False Claims Act (FCA). The FCA is a federal law that imposes liability on any person who knowingly presents a false or fraudulent claim for payment or approval to the U.S. government. These court actions are based on allegedly false loan-level certifications and annual certifications by lenders. The penalties are severe – lenders can be liable for three times the damages sustained by HUD, plus civil penalties of up to $11,000 per transaction. Since May 2011, HUD and the DOJ have filed and/or settled five cases against lenders, with settlement amounts ranging in four cases being $132.8 million, $158.3 million, $202.3 and $1 billion.[19]

The prospect of tough administrative and legal enforcement actions provides strong incentives for lenders to carefully follow FHA program guidelines. These enforcement actions also increase revenue for the MMI Fund.

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[15] Mortgagee Letter 2010-02.
[16] Mortgagee Letter 2010-03.
[17] 24 CFR Part 203.
[18] U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 61. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf
[19] Schulman, P.L., Baugher, K. M. (2012). Triple Trouble. Mortgage Banking, 72 (10), pp. 61-62.

There is a point, however, where harsh enforcement actions can have negative consequences for the FHA and eligible borrowers. While some in Congress and other policymakers may believe that additional FHA lender enforcement tools and legal actions were necessary to contend with some of the real and alleged lending abuses that occurred in the past by companies, it is undeniable that the increase in intensity of lender enforcement has contributed to a constriction of credit. Blunt tools, such as "zero-tolerance" lender enforcement, only serve to cause lenders to restrict lending to qualified borrowers for fear that minor, unintentional, and immaterial mistakes will serve as reasons for requiring indemnifications, or worse, as the basis for a False Claims lawsuit. Indemnifications or FCA lawsuits present problems for lenders, but they can be catastrophic for smaller independent mortgage bankers and community banks.

When lenders must operate their businesses within standards that permit virtually no errors of any sort or otherwise face substantial financial penalties, they will naturally restrict their underwriting to be well within the boundaries of permissible lending. Thus, overlays that include higher credit scores, lower debt-to-income ratios, and reserve requirements – all above and beyond the official FHA program guidelines – become logical outcomes to mitigate lender risk. This response from lenders directly impacts consumers by eliminating borrowers who could possibly be responsible homeowners, but have a few risk factors. Given the high stakes of indemnification or lawsuits, it is difficult for lenders to justify taking a chance on marginal borrowers – much of FHA's targeted population.

Let me be clear: as FHA commissioner, I initiated tighter controls and enforcement procedures that shut down irresponsible FHA lenders. When warranted, this is the right thing to do for the Fund and the market. Dishonest or sloppy lenders have no place within the FHA program. However, FHA must take a balanced approach to enforcement; otherwise FHA's practices risk a curtailment of sustainable credit at a time when credit is needed to support the housing market recovery.

MBA unquestionably supports high standards for all lenders that participate in FHA programs in order to protect the agency's viability, the lender's reputation, and the reputation of the industry. MBA members recognize and accept accountability for instances of fraud and negligence within their control. Moreover, lenders take full responsibility for underwriting mistakes that lead to loan delinquencies and incorporate sophisticated quality control systems to minimize the possibility of indemnifications. There must, however, be a reasonable allowance for human error, certainly when the error is not the cause of the delinquency or default. MBA would staunchly oppose efforts that allow FHA to go beyond reasonable standards of lender enforcement.

Servicing Loss Mitigation

FHA has taken proactive, appropriate, and aggressive steps to manage its 2000 to 2009 books-of-business, which include the agency's most costly loans. MBA commends these efforts, given that FHA already holds the risk on the loans. MBA also recognizes that additional steps may be necessary to further minimize losses. Below are MBA's thoughts on various means FHA is employing or considering to further reduce losses.

Launch large-scale proactive modification and partial claim campaigns for delinquent borrowers

During recent years, HUD has promoted several programs to assist borrowers retain homeownership, including FHA's Home Affordable Modification Program (HAMP), which help homeowners experiencing financial hardship make their homes more affordable by reducing the

mortgage payment. Recently, HUD made revisions to its loss mitigation home retention options making it easier for borrowers to qualify for FHA HAMP partial claims[20] and modifications.

Enhancing loan modifications and partial claims have the potential to achieve FHA's objective of helping more delinquent borrowers return to performing on their mortgages and ultimately reducing losses from foreclosures. MBA is encouraged that this effort will yield positive results and truly make a difference for many borrowers.

MBA does recognize, however, that increasing the number of partial claims in the short-term will require more cash outlays from the MMI Fund. Unsuccessful partial claims are costly to the MMI Fund because they prolong non-performing loans and increase claim obligations, deterioration of property and other liabilities. However, MBA anticipates that the increase in partial claims and other loss mitigation solutions will result in long-term savings for HUD.

Encourage Pre-foreclosure Sales

A pre-foreclosure sale (PFS) is a "short sale" - a sale of the property in satisfaction of a defaulted mortgage even though the proceeds are less than the amount owed on the mortgage.

HUD has acknowledged that pre-foreclosure sales are beneficial in the economic recovery, and result in cost-savings for HUD. For these reasons, HUD plans to take steps to encourage more pre-foreclosure sales as an alternative to foreclosure.

Pre-foreclosure sales allow homeowners a quick resolution of a mortgage loan in default without experiencing the foreclosure process. HUD benefits by avoiding extended foreclosure and eviction periods during which debenture interest and claim expenses accumulate and when property damage can occur.

Modifying the rules on pre-foreclosure sales will allow borrowers who cannot and do not want to retain their homes dispose of them more quickly. However, modifying the rules also may increase strategic defaults by borrowers who are capable of repaying their debts. Such a result would increase overall losses for FHA. With proper controls, however, this risk can be minimized.

Enhance servicer performance management and oversight

HUD is in the process of implementing an enhanced servicer performance scorecard that we understand will include the following four core areas: i) foreclosure prevention; ii) loss mitigation engagement; iii) single-family default monitoring system (SFDMS) reporting; and iv) re-defaults. It is expected that the new scorecard will become the vehicle to determine loss mitigation incentives and treble damages for failing to engage in loss mitigation. Changes to the scorecard will require rulemaking and *Federal Register* notice and comment before they become effective. In addition, HUD will issue a Mortgagee Letter with further details.

[20] Under the Partial Claim Option, the Lender will advance funds on behalf of the Borrower in an amount necessary to reinstate the delinquent loan. The Borrower will execute a Promissory Note and Subordinate Mortgage payable to HUD. Currently, these Promissory or "Partial Claim" Notes assess no interest and are not due and payable until the Borrower either pays off the first mortgage or no longer owns the property.

The new scorecard changes how performance is measured, and will likely reduce HUD outlays of loss mitigation incentive payments and could increase the imposition of treble damages. Servicers depend on loss mitigation incentives to cover the enhanced servicing obligations imposed on them to administer delinquent FHA borrowers. Also, the new scorecard will provide a vehicle to impose treble damages for reporting issues and issues outside of the servicer's control (such as re-defaults) rather than on servicers' efforts to offer loss mitigation. We do not believe treble damages are the appropriate remedy in these cases. The changes, in turn, will result in additional overlays in origination to reduce the risk of default, which in turn will lessen the number of borrowers to FHA.

Accelerate Note Sales

As part of the effort to address the housing market's "shadow inventory" and to target relief to communities with high foreclosure activity, HUD has accelerated the use of note sales through the Distressed Asset Stabilization Program (DASP). This program enables HUD to sell severely delinquent loans insured by the FHA through a competitive bidding process in which loans are sold to the highest bidder, including non-profit and community-based organizations.
HUD benefits from the program because it does not have the expense of an extended foreclosure process, saving considerable money for FHA's insurance fund. Borrowers benefit because note holders have additional flexibilities to modify loans that FHA servicers do not have.

Home Equity Conversion Mortgage (HECM) Program

The independent actuary projects the economic value of the HECM ("reverse mortgage") portfolio to be negative $2.8 billion, compared to $1.4 billion in FY 2011.The major reasons for this steep decline are:

- Updated mortality and termination speeds. Expected termination rates are slower than projected last year, thereby reducing the economic value by $1.9 billion. Survivorship beyond 10 years results in a greater chance of loan balances exceeding property values and HUD realizing a loss.
- Higher rate of property conveyance at termination. Presently, about 70 percent of non-refinance loan terminations result in the conveyance of properties to HUD compared to about 70 percent of property sales being handled directly by owners or real estate executers historically. The new actuarial estimates use updated projection model rates based on this new reality. This change reduces the value of the Fund by $1.9 billion.
- Less optimistic baseline house appreciation rates. As discussed in the FY MMI Actuarial section, home price appreciations have been revised since the FY2011 Actuarial Review.[21]

In response to the actuarial findings, HUD has announced significant changes to the HECM program. MBA continues to support the HECM program and the association applauds FHA for devising a solution to immediately address problems with the HECM program but still allow seniors to continue to have viable reverse mortgage options. Effective April 1, 2013, FHA consolidated the Fixed Rate Standard program with the HECM Saver product, thus reducing the

[21] U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 50. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf

maximum amount of funds available to the borrower.[22] The HECM Saver allows the borrower to continue to have the predictability of a fixed-rate loan with lower upfront costs, but the borrower is not able to draw as much funds as the Fixed Rate Standard. Although only a few years old, the HECM Saver is proving to be cost effective for borrowers and financially prudent for FHA.

A key challenge HUD has faced in managing the HECM program has been its inability to move swiftly in making programmatic changes that could enhance the security and financial performance of the Mutual Mortgage Insurance Fund.

MBA strongly supports the changes recently proposed in the "HECM Stabilization Act of 2013" (S. 469) which would amend the National Housing Act to give HUD the authority it needs to quickly and thoughtfully make changes to the HECM program as market conditions warrant. MBA is concerned that if HUD is not granted this authority in a timely manner through the HECM Stabilization Act of 2013, or another similar mechanism, the agency will be forced to take drastic measures to severely curtail the program, thereby eliminating an important financial tool for American seniors. The HECM program is an important option for helping seniors to age gracefully and with respect; it should be preserved.

While MBA fully supports granting HUD the authority to make changes to the HECM program to guarantee its continued vitality, it strongly urges Congress to be mindful of the implications of how changes are implemented and asks that Congress set a two year review period for the proposed law to review its effectiveness. An over-correction in the administration of this vital program could drastically impact the availability of credit to this important and growing segment of the population.

Support FHA Multifamily and Healthcare Loan Programs

FHA is an essential source of the long-term, fixed-rate debt needed to build and refinance multifamily rental units for working families, seniors, and underserved populations as well as for affordable, good quality healthcare facilities. Not only do multifamily and healthcare loans perform well with low default rates, but the programs generate funds for the federal government in the form of negative credit subsidy. In recent years, FHA has restructured the business operations for multifamily and healthcare lending making them more efficient. Additionally, according to the FHA Annual Management Report for FY 2012 released by HUD on November 15, 2012, refinances accounted for 73 percent of the FY 2012 FHA multifamily originations, thus stabilizing multifamily housing resources.[23] When an FHA loan is refinanced, it further protects the HUD's GI/SRI Fund.

Recently, FHA notified Congress that it had exceeded 75 percent of its commitment authority available to insure mortgages under the GI/SRI Fund under the first Continuing Resolution. It expects to run out of commitment authority again, perhaps as soon as July. MBA supports the authorization of an additional $5 billion in FY 2013 commitment authority to FHA for multifamily and healthcare programs. Without the additional $5 billion in commitment authority, it is possible that these important programs will experience disruptions. The variety of loans in this program, originated by 89 active FHA lenders, with funding from investors, insured by FHA and securitized by Ginnie Mae, represent a significant, stable source of capital for properties that

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[22] Mortgagee Letter 2013-01.

[23] Federal Housing Administration, FHA Annual Management Report, Fiscal Year 2012 (November 2012) at p. 29. Can be accessed at:
http://portal.hud.gov/hudportal/documents/huddoc?id=FHAFY12AnnualMgmntRpt.pdf.

might not be served by other capital market sources.[24] FHA multifamily loans serve properties with Low Income Housing Tax Credits, properties receiving project based rental assistance contracts as well as housing for households earning 60 to 80 percent of average median income. FHA's longer term mortgages, unlike the 7 to 12 year terms available in the conventional market, are crucial for affordable multifamily housing properties. HUD's own economic analysis of its healthcare programs states that they provide significant economic stimulus during construction and afterwards with new healthcare jobs.

Finally, MBA recommends that Congress ask HUD for transparency in FHA data for multifamily and healthcare loans so that Congress and the public can readily access specific performance data on multifamily and healthcare loans in the GI/SRI fund. The result should be a better understanding of the financial success or risks in FHA multifamily and healthcare programs.

Potential Impact on FHA from other Regulatory Initiatives

Potential changes to FHA cannot be viewed in isolation. Over the last five years, following the mortgage crisis, a host of major rules are in the process of changing the face of mortgage finance. Many of these changes are welcome and overdue, while others are concerning. All will permeate the financial system and FHA. And as these changes come on line, their impacts must be carefully assessed through the prism of how they will serve consumers and the nation. Two major rules deserve particular attention.

FHA Qualified Mortgage

The Dodd-Frank Wall Street Reform and Consumer Protection Act required the Consumer Financial Protection Bureau (CFPB) to issue rules implementing the law's "Ability to Repay" provisions and to define a class of "qualified mortgages" (QM) that would receive some degree of legal protection in the event of undue litigation concerning the origination of the loan. The law further authorizes HUD, the U.S. Department of Veterans Affairs, and the U.S. Department of Agriculture, in consultation with the CFPB, to prescribe rules defining types of loans they insure, guarantee or administer that are QM loans, which may revise, add to, or subtract from the CFPB's definition. FHA loans comprise approximately 30 percent of today's mortgage market. For several reasons, MBA has strongly urged the CFPB to eliminate the distinction between FHA QM safe harbor and FHA QM rebuttable presumption loans or at least raise the APR threshold to more realistically define FHA QM safe harbor loans considering the inclusion of the MIP in the APR for FHA loans.

The CFPB's final rule makes clear that the bifurcation between QM safe harbor loans and QM rebuttable presumption loans is intended to provide greater recourse to subprime borrowers. FHA loans, however, are not "subprime." They are subject to government oversight and significant regulation. FHA loans are generally fixed-rate and adjustable loans are subject to extremely tight adjustment limits to protect borrowers. All loans must be fully-documented, meet minimum downpayment and other requirements, and loans with credit scores under 620 now must also meet DTI requirements. Given the parameters of the FHA program and its regulation of all aspects of the process, MBA believes its borrowers are already well protected. Establishing a cutoff for FHA safe harbor loans will only add regulatory burden without providing any offsetting benefit.

[24] *Ibid* at p. 27.

MBA strongly believes that for the foreseeable future lenders will be extremely wary of originating loans that fall outside of the QM safe harbor. Consequently, if the APR threshold is not at least expanded, the availability of FHA credit for underserved populations – first-time, minority, and low- and moderate-income borrowers – may be unduly limited, jeopardizing FHA's ability to fulfill its important role.

Qualified Residential Mortgage

Another outstanding issue that will have a profound impact on FHA is the proposed risk retention rule. The Dodd-Frank Wall Street Reform and Consumer Protection Act require mortgage securitizers to retain five percent of the credit risk unless the mortgage is a Qualified Residential Mortgage (QRM). The proposed rule issued by six federal regulators nearly 20 months ago would require families to make a 20 percent downpayment and meet relatively low DTI and other stringent requirements. It is not at all clear from the proposal whether the regulators reflected on the relationship between the proposed QRM definition and the FHA's eligibility requirements in light of FHA's statutory exemption from risk retention. The proposed QRM definition appears to conflict directly with the Administration's plan for reforming the housing finance system because it would make it far more difficult for private capital to re-enter the housing finance market. In its white paper, the administration made clear that it intends to shrink FHA from its current role of financing one-third of all mortgages, and one-half of all purchase mortgages.

MBA supports FHA's role as a source of financing for first-time homebuyers and other underserved groups. However, because of the wide disparity between FHA's downpayment requirement of 3.5 percent and the QRM requirement of 20 percent, MBA believes the proposed risk retention rule would force over-utilization of FHA and other government programs. While FHA should continue to play a critical role in our housing finance system, MBA firmly believes that it is not in the public interest for a government insurance program like FHA to dominate the market, especially if private capital is ready and willing to provide reasonable financing for the same borrowers.

Ginnie Mae

Ginnie Mae has played a significant role in helping to stabilize the housing market. Since the 2008 crisis, Ginnie Mae has provided $1.7 trillion in liquidity, directly providing housing opportunities for 7.1 million households.[25] Ginnie Mae's full faith and credit guarantee attracts capital from all around the world, lowering interest rates for borrowers using government loan products.

During the last three years, Ginnie Mae has nearly doubled its staff, specifically enhancing its risk monitoring and customer management functions. Additionally, Ginnie Mae has taken many steps toward modernizing its technology and infrastructure and hired a senior manager in 2012 to lead these efforts. The new technology completely replaces legacy systems used for issuing, administering and disclosing on its securities.

[25] Government National Mortgage Association, Annual Report 2012 (November 2012) at pg. v. Can be accessed at: http://www.ginniemae.gov/inside_gnma/company_overview/budget_performance/Annual_Reports/annual_report12.pdf.

Despite these advancements, Ginnie Mae needs to make improvements that allow the agency to be as agile and responsive as private sector entities. Improving Ginnie Mae's ability to respond to an increasingly complex market and risk environment should be a top priority. To that end, MBA has long advocated that in order for Ginnie Mae to operate in its most efficient and effective manner, it must have greater ability to act as a private corporation.

Ginnie Mae faces challenges driven by the budget and appropriations process, where the timeline from request to action can be as long as two years. This timeframe makes it difficult for Ginnie Mae to appropriately respond to unanticipated market needs, and imposes operational difficulties on the organization.

Ginnie Mae should be given the flexibility and financial resources to hire the appropriate number of qualified staff for its current and future needs. Furthermore, Ginnie Mae should be given the ability to recruit and pay staff at a higher federal pay scale, on par with other "professional-grade" cabinet, regulatory, and independent agencies that require specialized expertise, such as the Federal Deposit Insurance Corporation (FDIC) or the U.S. Securities and Exchange Commission (SEC). Additionally, MBA recommends that Ginnie Mae have the ability to more broadly utilize retention allowances, recruitment bonuses, and superior qualifications appointments.

Finally, the strength of Ginnie Mae's guarantee is based on its ability to make timely payment of principal and interest to global investors. The requirements involved with the government procurement process inhibit Ginnie Mae's ability to rapidly and effectively respond to market changes such as the default of a large lender. Providing Ginnie Mae with flexibility regarding hiring and procurement would allow the agency to be more effective in responding to potentially significant risk events.

Conclusion

MBA believes that FHA plays a vital role in the nation's housing finance system, and that its mission of serving underserved populations should continue. It is the MBA's position that the recent changes announced by FHA are fiscally prudent and warranted given the financial realities described in the Actuarial Review of FHA's MMI Fund for Fiscal Year 2012. As Congress examines the need for further FHA reform, its goal should be to balance FHA's risk mitigation with appropriate policies that allow responsible borrowers to have access to credit. If the pendulum swings too far in certain areas, such as lender enforcement, sustainable credit will be curtailed at a time when it is needed to support the housing market recovery.

MBA urges a balanced approach that will help FHA maintain its mission focus and remain fiscally sound over the long term. As that process continues, MBA looks forward to working with this subcommittee, others within the Congress, and the administration to help achieve this objective.

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TESTIMONY OF

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BEFORE THE

UNITED STATES HOUSE FINANCIAL SERVICES COMMITTEE
HOUSING AND INSURANCE SUBCOMMITTEE

HEARING TITLED

SUSTAINABLE HOUSING FINANCE: PERSPECTIVES ON REFORMING THE FHA

APRIL 10, 2013

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Introduction

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee; my name is Gary Thomas. I am a second generation real estate professional in Villa Park, California. I have been in the business for more than 35 years and have served the industry in countless roles. I currently serve as the 2013 President of the National Association of REALTORS® (NAR).

I am here to testify on behalf of the 1 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the importance of the Federal Housing Administration's (FHA) mortgage insurance program. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential American households. The Association has a long tradition of support for innovative and effective federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure federal housing programs meet their missions responsibly and efficiently.

FHA is an insurance entity within the Department of Housing and Urban Development (HUD) that ensures that American homeowners have access to safe and stable financing in all markets. FHA has insured home loans for more than 37 million American families since its inception in 1934 and has never required a federal bailout. While many so-called experts have questioned the program's recent performance, NAR would argue that FHA has demonstrated its considerable importance during the significant housing and economic crisis our country is still experiencing.

History of FHA

When FHA was created by the 1934 National Housing Act, the primary goal of the Administration was to insure loans for home improvements[1]. In the wake of the Great Depression, the nation's housing stock was crumbling. Houses were not being maintained or modernized and the result was a negative feedback loop of deteriorating living conditions and falling home prices. At the same time, painters, carpenters, landscapers, workers in the dozens of trades involved in making home improvements were without work. By creating an agency to insure small, private capital loans for home improvements, the federal government hoped to address these issues simultaneously.

While home improvement loans were the first listed aim of the National Housing Act of 1934 and the subject of the Act's first Title, the full scope of the law went further. According to the Report of the House Committee, the intent of the National Housing Act of 1934 was:

> "to improve Nation-wide housing standards, provide employment, and stimulate industry; to improve conditions with respect to home mortgage financing, to prevent speculative excess in new-mortgage investment, and to eliminate the necessity for costly second-mortgage

[1] 13 Wayne L. R. 651, 652 (1967)

> financing, by creating a system of mutual mortgage insurance and by making provision for the organization of additional institutions to handle home financing . . ."[2]

These goals were achieved not through small loans for home improvements, but through what would become the Act's more enduring legacy: mutual mortgage insurance. So from the beginning, FHA never made loans directly to consumers. Private lenders make FHA loans, and FHA insures the lender against loss. Authorized by Title II of the National Housing Act, FHA's mutual mortgage insurance sought to insure loans up to $16,000 for the purchase of new and existing homes and spread the loan amortization period over a 20-year period. Up to this point, most home loans were balloon loans that had to be refinanced every few years, subjecting consumers and the market to massive volatility. By spreading out the amortization, the government hoped to make the market more stable, and create predictability for both homeowners and the financial industry.[3]

A common misconception exists that the FHA mortgage insurance program was originally intended to only benefit low-income borrowers who could not afford a large down payment on a new home. While the original upper limit of $16,000 for a home loan may seem exceptionally small today, in 1930, the national median home value was $4,778.[4] Only 3.2 percent of homes were valued between $15,000 and $20,000.[5] The majority of homes were valued between $2,000 and $7,500, with the largest number between $3,000 and $5,000.[6] So an upper limit of $16,000 in 1934 was more than 300 times the value of the median American home at that time.

Of course, a $16,000 loan limit does not paint the entire picture of FHA's target demographic. To better understand this, we should look at how the program was used by borrowers. In its third annual report to Congress in 1936, FHA's statistics showed that most of the homes insured were valued in the $3,000 to $6,000 range and the average single-family home value for an insured mortgage was $5,497, more or less reflecting the average costs of homes at the time.[7] Only 2.8 percent of FHA-insured homes were valued below $2,000, and only 2.1 percent above $15,000.[8] This is strong evidence that FHA's loan program was not originally targeted to any income group, but rather to help families across the income spectrum get financing to purchase homes. These statistics varied slightly from year to year, with the size of insured mortgages somewhat lower in 1937 (median $4,288), and then higher in 1938 (median $4,491).[9] [10] In general, these percentages

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[2] H.R. Rep. No. 1922, 73d Cong., 2d Sess. 1 (1934).
[3] First Annual Report of the Federal Housing Administration for the Year Ending December 31, 1934. U.S. Government Printing Office. 1935. p. 4
[4] Id. at 18
[5] 15th Census of the United States, Population, Volume VI: Families, U.S. Census Bureau, 1930, P. 17
[6] Id.
[7] Third Annual Report of the Federal Housing Administration for the Year Ending December 31, 1936. U.S. Government Printing Office. 1937. P.35
[8] Id.
[9] Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.58
[10] Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938. U.S. Government Printing Office. 1939. P.85

have mirrored the distribution of incomes of FHA-insured borrowers.[11] [12] A study of FHA's program recently reported that "The Section 203(b) program was clearly intended to deal with the vast bulk of the homeownership market, excepting only the wealthiest few…Thus initially, FHA was narrowly targeted to the promotion of single-family homeownership but broadly targeted to all but the lowest and highest income markets.[13]

In a similar vein, the original loan-to-value ratio (LTV) limit for FHA mutual mortgage insurance was set at 80 percent. While this is a high down payment requirement today, it was considerably less than what lenders had previously required. Home loans prior to FHA had downpayment requirements as high as half the value of the home, and as a result the American homeownership rate in 1930 was below 50 percent.[14] Because FHA-insured loans were amortizing and thus inherently less risky for both borrower and lender, a lower down payment requirement was justifiable. When the last payment on the loan was made, the loan was paid off.

These changes proved very popular: nearly 60 percent of FHA-insured borrowers in 1937 had LTVs between 76 and 80 percent, a jump from 47 percent in the preceding year.[15] Indeed, the loosening of the down payment requirement proved successful enough for FHA to raise the loan to value ratio again in 1938 to 90 percent for some loans.

Over the next few decades, FHA continued to update a number of its core policies. In 1934, the loan term for FHA-insured loans was 20 years. By 1954, FHA had changed its loan term to 30 years, a term that is still in place today. While the original downpayment for FHA loans was 20 percent, it was lowered to 5 percent by 1950 and to 3 percent in 1961. This downpayment stayed in place for 47 years, until Congress increased it to 3.5 percent in 2008.

Role of FHA During the Recent Housing Crisis

FHA has sustained housing markets nationwide during the worst economic crisis of our lifetime. As private lenders fled and financial institutions went out of business, FHA remained in the market and provided insurance to more than 4 million families since 2008. In a time when many of the large private banks, investment firms, and other financial institutions have needed bailouts or have even collapsed, FHA has weathered the storm very well. FHA continues to have significant resources sufficient to pay 30 years' worth of expected claims on its portfolio, an amount 30 times more than that required of banks, which are only required by the Financial Accounting Standards Board

[11] Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.61

[12] Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938. U.S. Government Printing Office. 1939. P.91

[13] Vandell, Kerry D. FHA Restructuring Proposals: Alternatives and Implications. *Housing Policy Debate*, Volume 6, Issue 2, Fannie Mae, 1995.

[14] 15th Census of the United States, Population, Volume VI: Families. U.S. Census Bureau, 1930. P. 12

[15] Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937. U.S. Government Printing Office. 1938. P.60

(FASB) to hold one year of reserves. In addition, FHA continues to have additional reserves in the Mutual Mortgage Insurance[16] MMI Fund of more than $2.5 billion. This is truly an achievement; FHA should be lauded for its financial stability in a most challenging environment and held up as a standard for strong underwriting and risk avoidance.

This recent period is not the first time FHA has played a counter-cyclical role. The FHA helped stabilize falling home prices and made it possible for potential homebuyers to get the financing they needed when recession prompted private mortgage insurers to pull out of oil producing states in the 1980s. According to HUD Secretary Shaun Donovan, "FHA picked up private market slack in Texas, Oklahoma and Louisiana during the Oil Patch bust in the late 1980s and in Southern California during the early 1990s, and it is playing this role again today."[17] Between 1986 and 1990, FHA's market share increased dramatically, as private lending tightened up or left. A GAO report said of the time, "private mortgage insurance (PMI) companies change the conditions under which they will provide new insurance in a particular geographic area to reflect the increased risk of loss in an area experiencing economic hardship. By tightening up the terms of the insurance they would provide, PMIs may have decreased its share of the market in economically stressed regions of the country."[18] However, FHA continued to provide insurance to these areas, stabilizing housing prices.

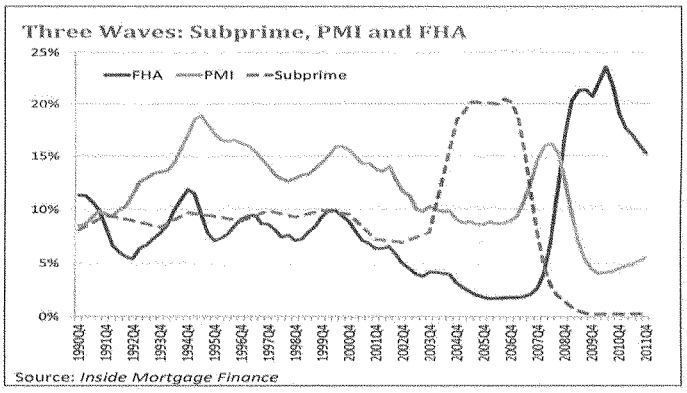

Figure 1[19]

[16] The fund that retains FHA's single-family premiums and is used to pay lenders when insured loans default.

[17] Written Statement of Secretary Shaun Donovan U.S. Department of Housing and Urban Development Hearing before the Subcommittee on Transportation, Housing and Urban Development, and Related Agencies Committee on Appropriations United States Senate, "The Role of the Federal Housing Administration (FHA) in Addressing the Housing Crisis," Thursday, April 2, 2009.

[18] GAO, FHA's Role in Helping People Obtain Home Mortgages, August 1996, GAO/RCED-96-123.

[19] Quercia, Roberto G. and Park, Kevin A, Sustaining and Expanding the Market: The Public Purpose of the Federal Housing Administration, UNC Center for Community Capital, December 2012.

As private lending constricted (and in some markets, disappeared altogether), FHA's role in the market grew. As recently as 2006, FHA's share of the home mortgage market was down to 3 percent, as unscrupulous lenders lured FHA's traditional constituent to risky exotic mortgages with teaser rates and little to no underwriting criteria. As the housing market began to collapse, private lenders fled or went out of business. As is seen in Figure 1, FHA's share of the loan market began to grow, as the private market's share plummeted. This demonstrates the counter-cyclical role FHA plays in the market.

Mark Zandi of Moody's Analytics has pointed out that "If FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it."[20] Moody's has estimated that without FHA, housing prices would have dropped an additional 25 percent, and American families would have lost more than $3 trillion of home wealth.

Instead, FHA continued to lend. From 2007-2009, FHA financing helped more than 1.8 million American become homeowners. Even more importantly, FHA helped stabilize housing prices in thousands of communities by providing access to home financing when few others would. A recent University of North Carolina study noted that "Private mortgage insurers implemented 'distressed area' policies making it almost impossible to obtain conventional mortgages with LTV ratios greater than 90 percent in some regions of the country. In contrast, FHA does not vary its insurance premiums by region, creating an automatic regional stabilization policy."[21] This counter-cyclical role of FHA helped stabilize markets and slowed the downward spiral of housing prices and economic decline (see Figure 2).

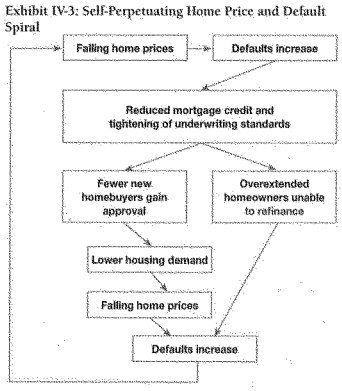

Figure 2[22]

[20] Zandi, Mark, Obama Policies Ended Housing Free Fall, *The Washington Post*, September 28, 2012.
[21] Quercia, Roberto G. and Park, Kevin A, Sustaining and Expanding the Market: The Public Purpose of the Federal Housing Administration, UNC Center for Community Capital, December 2012.
[22] Szymanoski, Edward; Reeder, William; Raman, Padmasini; and Comeau, John "The FHA Single-Family Insurance Program: Performaing a Needed Role in the Housing Finance Market", PD&R Working Paper No. HF-019, December 2012.

Had FHA not stepped in and filled this mortgage insurance void, many neighborhoods would have been devastated and our economy will still be in a recession.

Some have criticized FHA for the high foreclosure rate on loans it insured during the period of the crisis. It is true that these loans have had a serious impact on the health of the Mutual Mortgage Insurance Fund (MMIF). More than $70 billion in claims that FHA has filed can be attributed to the books of business made in 2007-2009. Housing prices continued to decline through 2009. Lending in declining markets raises risk. FHA and private insurance and lenders that remained in the market during that time period were all impacted. This was not a result of lax underwriting or inappropriate lending. FHA's most recent survey of the drivers of default showed that for the past 4 years, the overwhelming reason for delinquency has been reduced employment and reduced income – accounting for nearly 50 percent of all delinquencies for the past 10 quarters (see Figure 3).

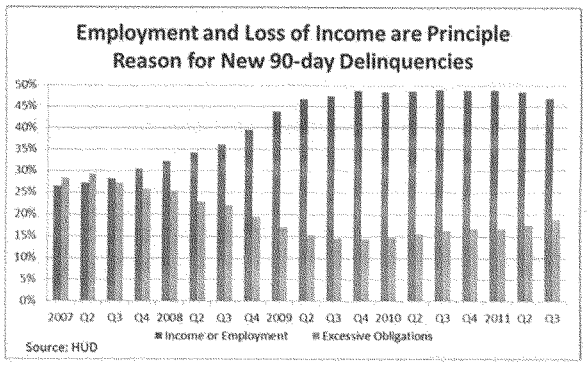

Figure 3

No one can be expected to predict the job loss and other fallout a household may suffer from a recession. Federal Reserve Chairman Ben Bernanke has said that, "an increasing share of losses have arisen from prime mortgages that were originally fully documented with significant down payments, but have defaulted due to the weak economy and housing markets."[23] In 2009, even the Congressional Research Service cleared FHA from blame noting, "FHA would not be able to prevent defaults arising from deteriorating financial and macroeconomic conditions."[24] Home prices have fallen 33 percent since 2006, causing much of FHA's financial decline. On a very basic level, the actuarial report analyzes the value of FHA's outstanding mortgages as compared to the value of

[23] Speech by Federal Reserve Chairman Ben Bernanke at the At the 2012 National Association of Homebuilders International Builders' Show, Orlando, Florida, February 10, 2012.

[24] CRS Report R40937, *The Federal Housing Administration (FHA) and Riskey Lending*, coordinated by Darryl E. Getter.

the homes. As housing prices have fallen, so has the value of FHA's books. As a participant in the home mortgage process, FHA cannot be immune to the pitfalls of the housing crisis. Solid underwriting policies and safe lending practices have protected it from the biggest failures.

FHA Today

Loans insured by FHA require full documentation of borrower income and assets. During the height of the real estate bubble, FHA was marginalized while exotic mortgages such as stated-income loans and payment option adjustable rate mortgages became common practice. When the bubble burst, these subprime and often predatory loans were prohibited by the regulators, leaving the industry searching for a stable mortgage product. Lenders using FHA are required to examine an applicant's financial status including income, debts and obligations. Generally, the monthly mortgage payment may not exceed 31 percent of a borrower's gross income and 43 percent of all debt payments.[25] Borrowers are required to have a 3.5 percent downpayment and closing costs may not be considered part of this financial contribution.

Recognizing the impact foreclosure has on communities and homeowners, FHA offers several programs to minimize risk to the MMIF and help families facing financial hardship stay in their homes. FHA may offer a loan modification, special forbearance, a partial claim, or foreclose on the property. Loss mitigation programs are available for both forward and reverse mortgages insured by FHA. Payments by FHA to a lender through loss mitigation do not impact taxpayers or the federal budget because they are derived from insurance payments made by FHA borrowers.

FHA continues to play a significant role for first-time buyers and minorities. In 2012, 78 percent of the 700,000 purchase loans FHA insured were for first-time buyers. Since 2009, FHA has insured mortgages for more than 2.8 million first-time buyers. Were it not for FHA, these buyers would not be homeowners, and 2.8 million homes would still be on the market. This would have been devastating on our nation's economy. Half of African-American homebuyers and nearly the same percentage of Hispanic and Latino buyers who purchased in 2011 used FHA financing. Even in 2001, before the crisis, more than twice as many minority first–time buyers used FHA than a loan that was guaranteed by Freddie Mac or Fannie Mae.

Since the crisis, the quality of FHA borrowers has skyrocketed. The average FICO score of an FHA borrower in 2012 was 699. The average FICO score on denied FHA applications was 670. Less than 4 percent of all FHA borrowers in the first half of 2012 had credit scores below 620. Figure 4 illustrates that FHA's denials in 2012 are higher than loans accepted in prior years. This figure also demonstrates that private lending has constricted to the degree that borrowers with credit scores over 730 are now being denied access to conventional credit. This draws more borrowers to FHA.

[25] HUD 4155.1 4.F.2.B and HUD 4155.1 4.F.2.C

Some have criticized FHA for lending to borrowers with such high credit scores. But if they are denied a loan in the private marketplace, where else can they turn? This is exactly FHA's role – to lend to the underserved. As hard as it is to believe, borrowers with credit scores below 760 may be underserved by the private market.

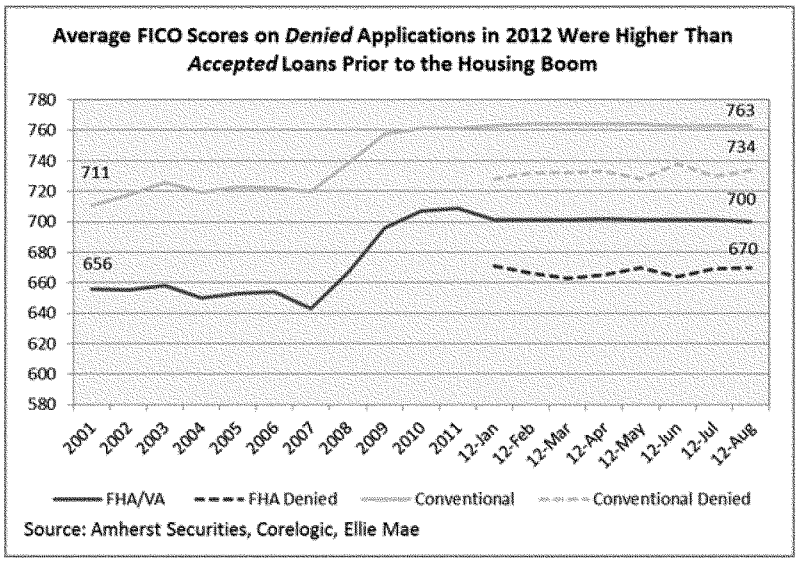

Figure 4

The private market is returning, albeit slowly. As Figure 1 demonstrated, FHA's market share is declining, as private lending tentatively re-enters the marketplace. PMI's business has increased by 60 percent over where it was in 2011, and 40 percent higher than in 2010 (Figure 5).

While economic conditions have limited private market participation, the regulatory and oversight landscape also has made lenders very wary of making home loans. Upfront charges for loans financed by the GSEs (called loan level pricing adjustments) and representation and warranty risks are significant factors. While lenders received clarity on new origination standards with the release of the qualified mortgage rule (QM) in January, fundamental changes to the structure of the secondary mortgage market are necessary before the role of the private market can be fully restored. Both the government and private sector issue mortgage-backed securities (MBS), which are bundles of mortgages sold to investors. Investors in privately-issued mortgage backed securities (PLS) experienced severe losses during the housing bust and questions have been raised about the quality

of loans in the securities. As a result, since the housing downturn investors have favored MBS backed by Ginnie Mae, Fannie Mae or Freddie Mac because of the government guarantee and stronger underwriting and transparency. This need to restore investor confidence is critical to strengthen the private sector.

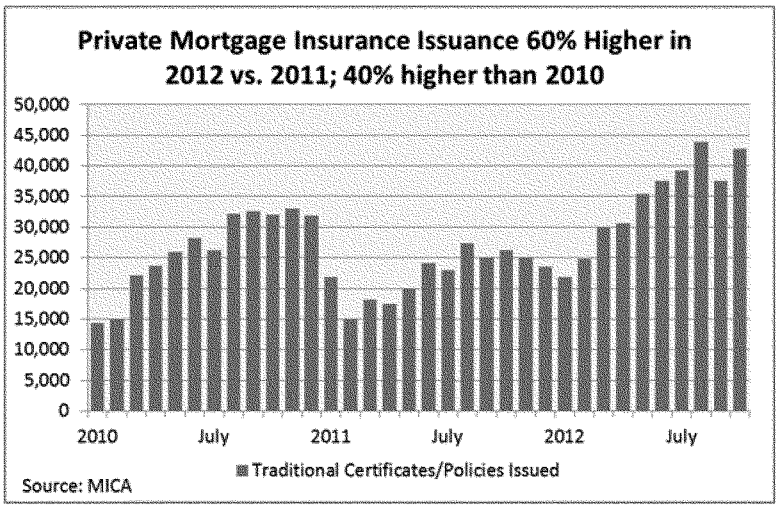

Figure 5

There has been much said about FHA's market share. To clarify, 15.8 percent of all people who purchase a home use FHA-insured financing. In recent years, the number of people paying cash for a home has increased. So when looking at all the people who use a mortgage to purchase a home, 26 percent of those buyers use FHA-insured financing. Most private lenders today require a 20 percent downpayment. For those who allow a smaller downpayment along with some kind of mortgage insurance, 44.6 percent of those loans are FHA-insured.

The National Association of REALTORS® welcomes a return of a robust private market. But we are not there yet. One needs only to look to markets not well-served by the FHA loan program– such as loans above $729,750 or the condominium market. Credit in those markets is very tight, requires significant cash down payments, or is simply unattainable. We strongly caution against actions to precipitously lower FHA's share of the market. We believe such changes at this time will simply lower the overall pool of mortgage credit available – keeping more credit-worthy borrowers from being able to own a home of their own. When regulatory uncertainty is resolved, and there is a known future of secondary mortgage credit, private lenders will return.

Mutual Mortgage Insurance Fund (MMIF)

It is likely that FHA will need to borrow money from the Treasury this year, but it is important to look at why. FHA did not offer risky mortgage products. FHA did not engage in exotic underwriting. FHA did not have accounting problems or other unscrupulous behavior. Instead, FHA stepped in during our housing crisis, and provided access to mortgage credit to millions of responsible Americans who wanted to purchase homes. Many of the mortgages FHA entered into during the crisis were in declining markets. Lending in declining markets increases risk. However, had FHA not stepped in to fill that market void, our economy would still be far from recovered.

Although the Federal Credit Reform Act (FCRA) and FHA's 2 percent capitalization ratio may require FHA to borrow from the Treasury, that money will not actually be spent to pay claims. The actuarial study predicts that FHA has sufficient resources to pay 7-10 years' worth of claims right now – even with no future business. But the Treasury draw may be necessary to hold a reserve able to fully fund all claims over a 30-year period. In essence, FHA will simply be holding this money in reserve. This is money that the actuarial report says will be unnecessary by FY2014, when the FHA fund will return to self-sufficiency. Some have argued that such a requirement is a misuse of taxpayer money, when it is not needed to pay actual claims.

Another factor that has had a significant negative impact on FHA's mortgage insurance losses is the use of seller-funded down payment assistance. Downpayment assistance from the seller was never permitted by FHA, but in the 1990s, some organizations formed schemes to circumvent the widely accepted prohibition on seller-provided down payments by forming middle-man "charitable" organizations that funneled seller monies through to the buyer. As early as 1999, FHA proposed eliminating these loans. But FHA was unable to do so because of successful litigation to prohibit the ban. Finally, in 2008, FHA received legislative relief to prohibit these loans. However, the damage had been done. These loans reached a record default rate of 28 percent, and account for more than $15 billion of FHA's current deficit.

Looking forward, the more recent books of business are of the highest quality in FHA history. The projected performance of the recent books of business (FY10-FY12) has improved steadily in the last three audits. Even the FY12 Actuarial Review shows the FHA reserve fund will be fully capitalized again in FY2014, and will reach the desired 2 percent capital reserves ratio by 2017, which is above and beyond the required 30 years' worth of reserves.

Responses from FHA

Over the past four years, FHA has made many administrative changes to mitigate risk. FHA has increased mortgage insurance premiums (MIP), implemented a credit score floor, required a greater downpayment for borrowers with lower credit scores, adopted a series of measures to increase lender responsibility and enforcement, and hired the agency's first Credit Risk Officer,.

FHA has increased its premiums five times in the last 4 years, to a now historic high level. Beginning April 1, 2013, the annual premium for new mortgages less than or equal to $625,500 and

LTVs greater than 95 percent is 1.35 percent. The annual premium for new mortgages greater than $625,500 with LTVs greater than 95 percent is now 1.55 percent. FHA also removed the automatic cancellation of the annual MIP for fixed-rate mortgages with LTVs greater than 90 percent at origination. These borrowers will have to pay the annual MIP for the life of the loan beginning June 3, 2013. While these changes may be necessary in the short-term, we encourage FHA to reconsider the need for these charges when mortgage markets stabilize and the FHA fund returns to full capitalization.

FHA has also instituted changes to low credit score borrowers. Borrowers with a credit score below 500 are not eligible for FHA-insured mortgage financing, and those borrowers with credit scores between 500 and 579 are required to make a larger 10 percent downpayment. FHA has also increased the downpayment (as well as imposed an additional premium increase) for borrowers with loans above $625,500 from 3.5 percent to 5 percent. NAR strongly opposes this increase, as the actuarial report has repeatedly shown that the higher limit loans perform better than the rest of the portfolio, and thus are helping the financial standing of the FHA fund.

FHA's Role in Multifamily Markets

As in the single-family market, FHA's role in multifamily mortgage markets has never been more critical. More than one third of American families rent their homes, and keeping a sufficient supply of affordable rental housing is essential. Without the liquidity provided by FHA multifamily mortgage insurance, these markets would be stalled.

In recent years, FHA's role in the multifamily market has increased dramatically – nearly 4 times its size from just several years ago. As lenders remain slow to provide financing for construction loans, FHA is the primary source of construction for multifamily developers and owners. Again, this demonstrates FHA's ability to step up and fill the gap when private markets will not or cannot act.

FHA has implemented a number of new procedures and requirements for its multifamily loans. They have strengthened underwriting by changing ratios and increasing documentation. They have also implemented a number of oversight and risk-management provisions.

In response to the increased demand and the changes to the program, FHA's ability to meet the needs of developers to create affordable rental housing has been challenged. FHA is working hard to meet the new demands responsibly. We urge them to look for ways to continue to streamline procedures.

At the same time there are significant concerns about the level of commitment authority the multifamily insurance program has for FY13. FHA reached the 75% limit of its commitment authority to insure mortgages under the General Insurance/Special Risk Insurance (GI/SRI) Fund for multifamily rental and health care facilities before the expiration of the first Continuing Resolution (CR). NAR urges Congress to provide FHA with an additional $5 billion of

commitment authority to ensure continued access to these important programs. The FHA multifamily mortgage insurance programs generate enough revenue to cover their cost, thus the additional commitment authority would not require any budget offsets.

NAR Recommendations

NAR recognizes the challenges that FHA is facing today, and the concern about risk to taxpayers. We believe FHA has taken a number of significant steps to immediately replace their reserves - including increases to premiums, risk management controls and downpayment increases. We believe these changes are and will continue to make substantial improvements to the FHA loan program's financial condition. However, there are additional reforms that we believe will further enhance FHA loan programs and protect the availability of mortgage credit to millions of American families.

Program Flexibility

Some of the losses that the FHA mortgage insurance program has faced in the last decades stem from programs it knew were problematic, but were powerless to change. As early as 1999, FHA reported problems with the seller-funded downpayment assistance program, but it wasn't until it received Congressional relief in 2008 that it was able to halt the program. That delay increased these defaults. The recent concerns about the Home Equity Conversion Mortgage (HECM) program provide another example. FHA would like to modify and restrict the use of this program which is contributing to significant losses. But it cannot make those changes without a rigorous regulatory process that will take months, if not years.

We support legislation to provide FHA with flexibility to change program requirements when necessary to protect the Fund. These include greater flexibility on setting premiums, changing loan policies, and other program changes. We believe FHA should have to go through some public notice process for significant changes, but don't believe the Agency should have to go to Congress for every program change.

Emergency Authority

On a related note, there are sometimes emergency changes that the FHA mortgage insurance program could benefit from if it could move quickly, that today require the regulatory process or Congressional action. We believe that FHA should be given temporary emergency authority to make changes to conditions that are having an immediate negative impact on the Fund. Congress could establish a threshold of impact (percent of defaults, or negative dollar impact on the fund) that would trigger such authority. FHA could make these changes for a set period of time (6 months or so) while it pursues the traditional notice or legislative changes. This would help FHA be more reactive and able to prevent losses in a timely fashion.

Risk Management Tools

FHA has made significant steps in lender oversight in the last several years. But there is more that can be done. We support legislation that provides FHA with authority to seek indemnification from direct endorsement (DE) lenders. Indemnification protects FHA from insurance claims where the lender is guilty of fraud, misrepresentation or noncompliance with applicable loan origination requirements. FHA currently has authority to require indemnification from lenders with Lender Insurance approval only. DE lenders represent 70% of all approved lenders, and Congress should require that FHA receive indemnification from them. This will provide significant level of protection for taxpayers when fraud has been committed.

Today FHA has limited ability to terminate lender approval. Congress should expand this authority and provide FHA more flexibility to review a lender's performance and terminate those lenders who have an unusually high rate of early defaults or claims. Again, this is simply a measure to protect taxpayers from bad actors.

Risk Based Pricing

Over the years there have been a number of proposals for risk-based pricing for FHA-backed loans. We believe this must be done in a very careful way so as not to disturb the "mutual" focus of the insurance fund, but NAR does support the concept. We believe risk based pricing that considers the full range of a borrower's qualifications could benefit the fund and allow FHA to better price risk.

Operations and Management

FHA continues to have significant needs with respect to its financial management systems and information systems in general. The HUD Inspector General recently downgraded FHA's financial management system as a material weakness of the program. We strongly support additional resources towards this effort, to ensure that the FHA mortgage insurance program is operating efficiently and soundly.

Other Programmatic Proposals

There are a number of other proposals that have been suggested that NAR believes are worthy of additional discussion. Creating a risk-sharing model for FHA with private mortgage insurance companies is one such proposal. Such an idea, called Ginnie Mae (GNMA) Choice, was proposed a number of years ago. It was a pilot program, capped at 20% of GNMA volume. While NAR did not support this particular concept due to concerns about the potential for cherry-picking the highest quality borrowers from FHA, we were intrigued by the concept. We believe further analysis of a risk-sharing proposal is warranted.

Some have suggested lowering the federal guarantee from 100%. Other federal programs – such as the VA home loan guaranty and the Section 502 Guaranteed Rural Housing Loan Program – have lower guarantee rates. But studies completed by GAO and others have noted tightening of credit and increasing costs as concerns with such a proposal. However, NAR is actively reviewing this idea.

While NAR does not currently support these proposals, we are analyzing these concepts and would benefit from additional information about them. We are specifically focusing on the impact on the future viability of the FHA program, housing consumers and real estate markets. We would very much like to be a part of any future discussion on these ideas.

Condominium Changes

Condominiums are often the only affordable option for first time home buyers. FHA updated the condominium rules in September of 2012, but we recommend additional changes that will provide greater liquidity to this sector of the real estate market without causing additional risk to the MMIF. We support enhancements and changes to the rules and limits relating to owner-occupancy, investor ownership, and delinquent home owner association (HOA) assessments.

NAR recommends elimination of the owner-occupancy ratio requirement for FHA condo mortgages. The GSEs do not have an occupancy ratio for condominium projects if the borrower is going to occupy the unit, which is the case for all FHA borrowers. Eliminating this requirement will allow more households looking for a principal residence to purchase condominiums, which are often more affordable, raise owner-occupancy levels, and stabilize these developments and their communities.

FHA should continue to provide additional flexibility on condominium recertification requirements and fidelity insurance coverage requirements. The existing rules place significant data and liability burdens on volunteer boards of condominium and homeowners associations and limit the stock of housing units available to FHA buyers.

Conclusion

The National Association of REALTORS® strongly believes in the importance of the FHA mortgage insurance program and believes FHA has shown tremendous leadership and strength during the recent crisis. Due to solid underwriting requirements and responsible lending practices, the FHA loan program has avoided the brunt of defaults and foreclosures facing the private mortgage lending industry. We applaud FHA for continuing to serve the needs of hardworking American families who wish to purchase a home; and we stand in support of its mission, its purpose, and its performance, particularly in times of a national housing crisis.

Written Testimony

of

Sarah Rosen Wartell

President, Urban Institute

for the hearing entitled

"Sustainable Housing Finance: Perspectives on Reforming FHA"

before the

House Financial Services Committee

Subcommittee on Housing and Insurance

Wednesday, April 10, 2013, 10:00 AM

2128 Rayburn House Office Building

Sarah Rosen Wartell is indebted to Ed Golding, Sharon Carney, and Matt Rogers for their assistance in preparing this testimony and to Mark Willis and other participants in a roundtable on the future of FHA for helping to shape some of the concepts described herein. The views expressed, however, are solely her own and should not be attributed to the Urban Institute, its employees, or any other person or organization with which she is affiliated.

Introduction

Chairman Neugebauer, Ranking Member Capuano, and Members of the Committee, I thank you for the opportunity to testify today about reforming the Federal Housing Administration (FHA) to ensure a sustainable housing finance system.

My testimony focuses on steps Congress can take **now** to improve FHA's financial health by strengthening its ability to assess and manage risk and mitigate loss. These proposals are aimed at helping the agency become more nimble, efficient, and capable of acting quickly to protect taxpayers. Some of these measures won broad bipartisan support from this Chamber last year, although I suggest some further refinements and additions to that legislation. I urge you to rapidly enact these achievable measures rather than let more time pass while costs mount to FHA. There is no reason FHA cannot perform better and strengthen its finances more quickly with your help.

At the same time that I urge you to take prompt action to help FHA strengthen its financial position, I suggest you **only** consider the broader issue of FHA's mission and place in the larger housing finance system in the context of housing finance system reform. Policymakers must resolve how to attract sufficient private capital to provide long-term, fixed-rate mortgages after Fannie Mae and Freddie Mac are wound down before we can understand what is left for FHA to do.

The good news is that FHA's market share has fallen and is on downward trajectory. The private market is slowly returning. With recent changes to its premium structure, FHA seems to now be more expensive than private mortgage insurance where available for low–down payment borrowers with better credit scores. Although the credit quality of FHA-insured lending right now is very high, the majority of FHA's loans are on terms that private insurers or the government-sponsored enterprises (GSEs) will not yet accept. In the past, after FHA played a critical countercyclical role, FHA's weakened capital reserves soon recovered and its market share shrank, allowing private capital to play a larger and larger role in the housing market. We seem to be on the same path again—to the good.

There are some policy measures under discussion that would limit access to FHA-insured mortgages artificially, rather than let market forces do their work. Some of these measures would do great harm to FHA's ability to play an indispensable countercyclical role in the future when needed. They also would limit FHA's ability to serve its ever-important mission of ensuring financing is available to creditworthy borrowers who have limited options in the private market.

What is more, it will be—at a minimum—many months until there is legislation that could pass this body and be signed by the President on broader housing finance reform. The shape of the system that results will determine what role FHA must play. The need for FHA's full-loan insurance will be larger if the GSEs are unwound without a new, more limited, fully-paid-for liquidity guarantee. FHA can be assigned a more limited role under normal economic conditions if there is a replacement "conforming" market in which private capital stands in front of a catastrophic government guarantee.

I urge the Congress to tackle quickly what is possible and urgently needed: improvements to FHA's ability to manage risk and reduce losses. You should act to begin to bring down the FHA loan limits gradually, while continuing to recognize the different market conditions that exist in high-cost areas. If you choose to delay these measures while Congress debates broader mission questions for FHA and the system as a whole, the result will be further avoidable losses to the FHA fund. There is no reason not to take measures to protect taxpayers from those avoidable costs. You will have ample opportunity to consider FHA mission reform, as needed, in the context of future legislation. I hope you will consider these measures prerequisites to a broader legislative agenda for housing finance system reform.

My Background

For 20 years, I have worked on housing finance policy issues. I began my career in public policy with a five-year stint as an official at FHA, advising the FHA Commissioner and HUD Secretary on housing finance, mortgage markets, and consumer protection. I held a variety of positions at FHA including deputy assistant secretary for operations and associate general deputy assistant secretary for housing, and I helped develop a 1995 legislative proposal to transform FHA into "a results-oriented, financially accountable [government corporation known as the Federal Housing Corporation that would] utilize the strengths of private market partners to expand homeownership opportunities, …[while continuing] to serve the needs of working families who require low-downpayment loans, and residents in central cities, older neighborhoods, and other underserved markets, and develop more affordable rental housing."[1]

After HUD and my subsequent tenure as deputy assistant to the president at the National Economic Council in the White House, I served as a consultant to the bipartisan Millennial Housing Commission, where I wrote about how FHA faced management weaknesses and growing risk with inadequate risk management tools and evaluated the pros and cons of using single-family risk-sharing pilots to help FHA better protect taxpayers and serve its mission.[2] Later, in 2007, at the Center for American Progress, I convened the Mortgage Finance Working Group, a cross-sector coalition of individuals working to understand and develop policy responses to the emerging mortgage market crisis, which proposed one of the first plans to unwind the GSEs, bring private capital back into the system, and ensure public purposes are well served.

Now, at the Urban Institute, I am responsible for leading an organization that provides independent research and analysis on a wide array of issues, from tax policy to community development to health care and more. The Institute is working to launch a new research initiative with the capacity to provide data and analysis to inform policymakers on housing finance questions.

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[1] "Reinvention," by Henry Cisneros, June 29, 1995, available at http://archives.hud.gov/remarks/cisneros/whyhud/reinvent.cfm.

[2] Sarah Rosen Wartell, "Single-Family Risksharing: An Evaluation of Its Potential as a Tool for FHA," June 2002, available at http://govinfo.library.unt.edu/mhc/papers.html.

How FHA Got Here

FHA plays a critical countercyclical role in the housing market and the larger economy that requires taking risk. FHA tries to price for that risk accurately to absorb costs under most likely circumstances; but, like most housing market participants, it rarely gets it just right.

Like most insurance, during good times, the excess of premiums collected over the cost of claims builds up in the FHA fund, creating a capital reserve. But, low–down payment mortgages will experience elevated defaults when house prices fall and unemployment rises. Given that we have seen the worst housing downturn since the Great Depression, we should not be surprised to see that defaults increased and the MMI Fund experienced significant outflows.

There were two principal causes of recent losses. First, FHA insurance premiums were insufficient to cover costs of insurance buffeted by rapidly falling home values amidst a foreclosure crisis, falling incomes, and rising unemployment stemming from the deepest recession in many, many decades. In short, many of these losses were inevitable—the result of FHA playing an indispensable countercyclical role, without which losses to the U.S. economy, U.S. homeowners, and U.S. taxpayers through the conservatorship of Fannie Mae and Freddie Mac would have been far greater.

Second, FHA incurred costs that were avoidable. Many of its losses stemmed from specific products that performed badly. Even as their poor design became apparent, FHA had great difficulty shutting down these products. And as bad actors turned to FHA when other capital sources dried up, FHA was slow to identify and shut down ineffective originators and underperforming servicers. In many cases, FHA officials knew of the problems, but they are not able—as their private-sector counterparts are—to act quickly to avoid further losses. Rather, stemming these losses required lengthy rulemaking processes and even legislative requests, some of which have been pending before Congress since 2010.

A few other observations:

- The countercyclical nature of the FHA has helped avoid costs. During most of the worst origination years in the market (2005 through 2008), FHA had relatively low volumes. Thus, although the performance of those books was poor, as it proved to be for most market participants, the absolute size of the losses was less than it would have been if the poor performing books of business had been above average in size.

- The greatest net cost to the FHA Fund was at the pivot point, when private capital was fleeing the market and originators accustomed to generating lower-quality product looked for new outlets. Too much of that weak product ended up in FHA's portfolio before FHA could tighten its own standards. According to HUD reports, the worst years were 2007 and 2008:

> The (single-family) books-of-business insured prior to 2010 are expected to generate large losses for the MMI Fund. The peak book for losses per-dollar of insured loans is 2007, the year that also has experienced the greatest total decline

in home values. When that book is finally closed, its total cost is expected to exceed 11.3 percent of the initial dollar volume of loans insured. Though the 2008 book has a lower loss-per-dollar (7.7 percent), that book was three times as large as 2007, and therefore, has expected dollar losses that are more than twice those of 2007 book ($13.2 billion versus $6.4 billion).[3]

- As standards tightened across the industry and FHA tightened its own rules, while private lender competition for high-quality credit borrowers disappeared, the credit quality in FHA's book of business grew tremendously. So newer books of business start to have net economic value for FHA, allowing it to begin to rebuild its capital. By 2010, early defaults had dropped dramatically and premium income had grown, leaving actuaries to predict that the economic value of the post-2009 books of business would speed the replenishment of the FHA Fund.

- This phenomenon is typical of many insurance markets: the new books following the collapse are replenishing the fund. This ***diversification across time*** is an important element of insurance markets where there is high correlation of outcomes within the pool, such as property and casualty insurance. As former FHA Commissioner John Weicher, now of the Hudson Institute, tells the story, this pattern is very similar to that which FHA experienced in 1980 to 1982.[4]

- The increase in loan limits mandated by Congress also appears to have helped FHA to replenish the Fund. At a time when private capital and the GSEs were accepting only pristine credit with high down payments, higher-LTV larger-dollar loans for FHA appear to have strengthened the performance of the Fund.[5] As economic times improve and private capital returns, however, these non-mission-related, high-dollar insured loans should no longer flow into FHA's portfolio where they inflate the total amount of insurance exposure of the taxpayers, regardless of the economic value of those books of business. ***It is time for loan limits to come down, albeit gradually.***

- We learn (or relearn) from these periods that certain products and practices disproportionately contribute to loss. In general, reduced documentation, an abundance of second mortgages, and lax appraisals increase losses.

- In the case of FHA, seller-funded down payment assistance (SFDPA) and other seller contributions had much the same effect as second mortgages, which, along with lax

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[3] U.S. Department of Housing and Urban Development, *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2012*, November 16, 2012, at 42–43.

[4] Presentation by John Weicher at the American Enterprise Institute, January 24, 2013, available at http://www.aei.org/files/2013/01/24/-john-weicher-fha-presentation_110740723232.pdf.

[5] U.S. Department of Housing and Urban Development, slidedeck on *Annual Report to Congress, Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund*, November 16, 2012, available at http://portal.hud.gov/hudportal/documents/huddoc?id=111912FHAActRevPolResp.pdf.

appraisals, increased defaults in the program. For example, cumulative to date claim rates on the 2005 originations are over 20 percent when there was assistance from nonprofits compared to a rate of 9 percent when there was no assistance.[6] The Actuary estimated that SFDPA loans reduced the economic net worth of the MMI Fund by $15 billion. If FHA had never insured any SFDPA loans, the last actuarial report would have still shown a positive economic value for the Fund.

- The Home Equity Conversion Mortgage (HECM) program—the FHA program that first pioneered the reverse mortgage—has proven to be another major source of loss for FHA. When Ginnie Mae designed a securitization vehicle for HECMs in 2008, the product took off, with many lenders originating loans that allowed borrowers to take large cash amounts out of home value at one time, leaving them with limited resources to pay property taxes and other ongoing expenses. A well-designed HECM converts home equity into an annuity at reasonable rates for living expenses. Performance of HECMs is especially vulnerable to home value fluctuations. FHA has tightened these standards significantly, but its authority to make changes is limited, and the slow pace of the rulemaking process necessary to return the program to its intended purpose has left the door wide open with FHA continuing to incur losses as program changes make their way through the regulatory process. (See recommended additions to the FHA Fiscal Solvency Act below.)

Recommended Measures to Reduce Costs and Mitigate Risks

A key pattern emerges from looking at FHA's recent performance. When FHA incurred losses that it might have avoided—that is, those losses which were not fundamental to FHA's countercyclical role or the inevitable consequence of calamitous economic and housing market conditions—the losses stemmed from the slow pace of change at FHA and the ways in which a government agency cannot typically act as quickly as a private company can to protect itself against risk.

Think about the steps taken by the capital market investors to reduce their exposure to mortgages quickly as the market meltdown began. Think about how financial institutions tightened underwriting standards virtually overnight and dropped products that were proving to be expensive as soon as the costs were understood. Officials at a wide range of institutions exposed to mortgage credit risk, even at the GSEs, were able to comparatively quickly take steps to stop the bleeding. But not so at FHA.

HUD has recommended some legislative changes to help it reduce losses in key programs, including authority to seek indemnification from direct endorsement lenders, terminate origination and underwriting approval for inadequate lenders, transfer servicing by mortgagee letter, and revise the compare ratio requirement. Overall, I support the secretary's requests, and I discuss in the following sections some changes to current bill language to accomplish these goals. But I believe even more needs to be done, and, in some cases, the proposed changes are

[6] Ibid.

too timid. I recommend several actions that would better enable FHA to assess risk, act more nimbly to mitigate it, and, ultimately, operate more efficiently and sustainably. These recommendations promise quick impact, they are both politically and operationally feasible, and they are not mired in ideological debate. Rather, these are rational, responsible ways to reduce risk to taxpayers quickly.

- **"Risk management emergency powers: emergency authority to suspend issuing insurance under risky terms and conditions."** I propose a way to respond to the constraints of government processes, create greater transparency, and ensure opportunity for effective congressional oversight. Congress should give the HUD secretary special emergency powers to suspend FHA insurance programs or make emergency modifications to the program when the secretary finds that continuation under current program terms ***exposes the taxpayers to "elevated risk of loss" and "fails to serve the public interest."*** Any such emergency action to terminate insurance would need to be accompanied by analyses of (1) the potential cost savings to the FHA Fund and the taxpayer risk that would be avoided; and (2) whether the program objectives established by Congress would be furthered or harmed by temporarily suspending insurance until program terms and conditions can be altered. The emergency authority proposed here would be time limited, requiring the HUD secretary to complete all appropriate administrative procedures to make the change permanent (or seek congressional authorization if a statutory mandate was involved). Congress could at any time vote to disapprove the use of the emergency powers by the secretary if they felt the risk was not properly assessed or the change was not necessary to meet public ends.

FHA has also faced difficulty in establishing early-warning risk indicators and in taking steps quickly to stop specific originators from continuing to add loans to FHA's insurance portfolio which are markedly more likely than others to end in default. Commissioner Galante testified that HUD sought changes to the "statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance." Specifically, the secretary seeks to compare early defaults and claims by a range of factors including geography, underwriting, or populations served.

I believe the HUD secretary's request of Congress is too timid. It is in the public interest to empower the HUD secretary, who is overseeing a trillion dollars of taxpayer risk exposure, to use any early-warning indicator that evidence suggests is predictive of losses, provided that its use does not discriminate or otherwise violate the law. When HUD officials know that taxpayers are being exposed to undue risk, it shocks the conscience to say that they must continue to accept such loans for insurance pending administrative procedures and overcoming burdens of proof. We should want FHA staff to be able to continuously refine its early warning indicators, be transparent about the risks that it is seeing, and take steps quickly to adopt new tools as they become available.

I do understand that the implementation of the FHA Compare Ratio, like any other early-warning indicator, will potentially have unintended consequences that do not serve the public's interest. But it seems to me appropriate to shift the burden of proof, so that it is easier to protect taxpayers

against risk and harder to continue to originate questionable loans for the FHA insurance portfolio.

- **Early-warning risk indicators.** Congress should give the HUD secretary the authority to establish appropriate risk indicators on an ongoing basis and to use these indicators to limit access to participation in FHA insurance programs where these indicators suggest a lender, servicer, or other program participant is more likely to exposure the taxpayers to risk. When program participants can overcome a burden of proof that they do not pose undue risk or that a better indicator is available, then FHA's decisions can be subject to scrutiny. But the goal should be to give the taxpayers—not program participants—the benefit of the doubt.

Another concern is that FHA tends to adopt new programs or program changes for its entire portfolio. There are exceptions, of course. FHA did begin to pilot note sales before expanding the program. But too often, unlike private-market participants that will try out a new business practice or insure a small portfolio and test performance before applying a strategy to the whole business, the statutory and regulatory environment for FHA leads to "all or nothing" policy changes. The length of the administrative procedures required also leads to full implementation rather than testing, because an evolutionary or phased change strategy would require iterative regulatory changes and sap so much administrative energy. These practices inherently increase risks to the Fund because new policies go into effect without enough evidence of their likely impact.

- **Risk-reduction pilots—authority to pilot new policies to test their costs and benefits before implementation.** Congress should give FHA express authority to implement pilot programs quickly where the goal it so better understand, measure, and mitigate risk. Full implementation would follow normal administrative procedures. So, for example, FHA could test whether a new alternative underwriting standard (e.g., incentives for pre-purchase counseling), or loss mitigation procedures, or REO disposition approach can achieve program objectives in a cost-effective manner.

Finally, an ongoing concern is whether FHA has the systems, technology, and analytical prowess to reengineer business practices to reduce risk, to understand emerging risks in their portfolio before it is too late, and so on. Giving the HUD secretary authority to hire for risk management, analytic, and technological systems staff on a more generous pay scale could close some of the gap between private-market participants and those charged with protecting the taxpayer from economic harm. Bank regulators are compensated slightly better than other government officials so that the agencies can attract the talent with financial knowledge and analytic skills for effective financial regulation. And regulators can use funds assessed on those they regulate to support the operations, systems, and other needs of the agency to protect taxpayers from losses from insured depository institutions.

- **Allow FHA to hire for select positions at elevated compensation levels to ensure that FHA can attract appropriate insurance, financial, and risk management**

skills. Also provide FHA with the ability to use insurance premiums for systems and analytical model acquisition to strengthen their capacity to mitigate risk.

The FHA Emergency Fiscal Solvency Act -- H.R. 1145 (2013)

Originally sponsored by Representative Biggert (R-IL) and passed by the House in 2012 with broad bipartisan support, this bill offers a good opportunity for improved risk management at FHA. However, a few additional authorities still sought by FHA should be included. And three important aspects of the bill should be revised before final passage. In each case, I urge Congress, who is hearing from concerned lender participants in the program, to keep in mind the taxpayer interest. Each time that we place greater burden on the agency before it can take steps to limit lender participation or require lender indemnification, we slow the agency's ability to protect taxpayers. The presumption should be in favor of reducing losses to the government and not allowing lenders to continue originating improperly originated FHA loans at a profit.

Revisions to Section 3: Indemnification by Mortgagees

Since 2010, HUD has sought to ensure that both direct endorsement (DE) and lender insurance (LI) lenders are liable to indemnify the secretary for losses on loans they originate that do not comply with FHA guidelines. The intent was to provide for equal treatment of both classes of lenders and empower the agency to reduce losses. Currently, FHA can only seek such indemnification from LI lenders. However, as written this legislation would weaken the current authority the agency already has for LI lenders, and it would create additional hurdles to recouping losses by (1) inhibiting FHA from pursuing indemnification from either type of lender until new regulations implementing the DE authority is promulgated, (2) retaining the "knew or should have known standard" for indemnification that the GSEs and other private actors do not use, and (3) requiring a new highly cumbersome consultation process before seeking indemnification.

While the intent of Congress is sound, the current language would impair FHA's ability mitigate losses in a way that private-sector counterparties do not suffer. The current bill's language is an example of how legislative compromise with private-sector program participants seeking more favorable treatment results in prescriptive procedures that cause harm to the taxpayer's interest. The original language sought by the secretary with a streamlined consultation process is a better course.

Revisions to Section 4: Early Period Delinquencies

FHA's Credit Watch Termination Initiative is designed to allow FHA to use metrics to compare the performance of lenders, focusing attention on those originating loans with a high proportion of serious delinquencies, and allowing them to more easily terminate lenders from the program. As I discussed in my own proposals, I believe FHA should be able to use any appropriate indicator to assess risk by simply making a finding of the evidence of its predictive power, so I recommend this section be modified to provide that flexibility. It is far too cumbersome for the

specifics of the early indicators to be in statute, because—as this process has shown—it can take years to get authority for revisions shown to be necessary to reduce loss.

HUD sought the ability to refine the indicators used so that they could vary by geographic area, underwriting standards, or populations served[7]—which would have accomplished some of the metric flexibility I recommend. However, the current version of this language would be administratively burdensome without providing sufficient additional loss avoidance to justify the level of effort. While I believe broader flexibility to establish the compare ratio and other early warning indicators is justified, at minimum, the definition of early period delinquencies should be revised to be consistent with industry standards: 60 days in default within six months.

Revisions to Section 7: Authority to Terminate Mortgage Origination and Underwriting Approval

This section, sought by HUD since 2010, would allow FHA to more easily terminate lender authority to originate FHA loans in a specified area or nationwide, if the lender is found to be causing undue losses to the Fund. However, the provision as written in the bill is limited to termination for "early" defaults. FHA should be able to terminate lenders in specified areas whenever their activity causes undue harm to the Fund, whether or not the undue defaults are early.

Further Additions: Authority to Transfer Servicing and Authority to Manage the HECM Program by Mortgagee Letter

Finally, I note that the most recent report from HUD on the financial status of the FHA MMI Fund 2012 included two new legislative proposals. In each case, I believe that the more general authorities to protect the taxpayer from risk that I propose above would be preferable. However, absent that, the requested provisions would help protect the FHA Fund from additional losses.

The first of these provisions is intended to allow FHA to deal with poor-quality servicing by lenders. The failure of lenders to take appropriate loss mitigation steps can result in higher than necessary claims to the FHA Fund and homeowners losing their homes unnecessarily. This authority will not only deal with ineffective servicers but create a powerful incentive for better servicing.

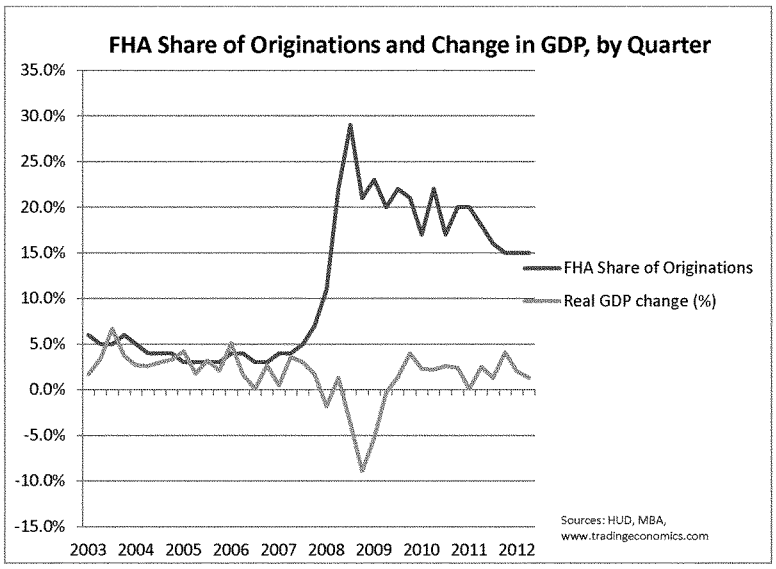
The second of these provisions would clarify that FHA can manage the HECM program, the origin of significant losses to the Fund in recent years, through mortgagee letter. This change would enable FHA to better respond to the market by implementing structural changes to programs with immediate effect. These changes would eventually be codified through the rulemaking process, and lenders would be able to suggest further modifications through notice and comment periods.

Crowding Out? FHA Market Share Is Declining—As It Should

[7] Specifically, in the FY2012 Actuarial, HUD sought the ability to revise the compare ratio.

Some have raised the concern that FHA has crowded out the private sector and that if it withdrew from the market, the private sector would step in. It is, however, difficult to disentangle whether FHA's higher share is the result of private capital leaving or FHA expanding—the classic "chicken or egg" question. The evidence suggests the former. FHA share grows when the economy is weak and contracts when economic growth returns.

Figure 1



There is also ample evidence that FHA is serving a market that other investors do not want. Today, the alternative to FHA is a high-LTV mortgage purchased by the GSEs (not exactly private capital) insured by private mortgage insurers. In effect, the market is segmented between the very safe high-LTV loans that the GSEs and mortgage insurers capture and the modestly riskier loans that FHA insures. In doing so, FHA serves predominantly first-time homebuyers, lower-income households, and minority households that the market otherwise would not serve. The data below highlight a few of the statistics that show this segmentation.

- In 2010, FHA served three times the number of first-time homebuyers (FTHB) as the GSEs.[8]

[8] Szymanoski, E. "The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market." 13: Exhibit II-1-A. Working Paper No. HF-019 available at http://www.huduser.org/publications/pdf/FHA_SingleFamilyIns.pdf

- In 2010, FHA FTHBs had on average 85 percent of area median income compared with 110 percent for GSE FTHBs.[9]
- In 2010, FHA served far more African American and Hispanic FTHBs than the GSEs did (approximately 210,000 families compared with approximately 70,000 families).[10]
- In 2012, Radian stated in its 10Q reports (page 99) that only 1.4 percent of its mortgages had LTVs above 95 percent; in fiscal year 2012, 72 percent of FHA mortgages had above 95 percent LTV.[11]
- In 2012, Radian stated in its 0Q reports (page 100) that only 18 percent of its borrowers had FICOs below 680, compared with 43 percent of FHA borrowers in fiscal year 2012.[12]

The above statistics are evidence that much of FHA's current business would not be served by the market in FHA's absence. As the economy continues to strengthen, FHA's share will naturally decline, as it should.

The one way in which I recommend Congress should limit FHA's market share today is to reduce loan limits. By raising the limits when it did, Congress provided support to a mortgage market in disarray, helping to stabilize the economy and support the FHA fund with stronger loans as it played a critical countercyclical role. The need for that support is easing as the housing market recovers in many higher-cost areas. Of course, loan limits should have regional variations to reflect different housing costs, as they have had in the past. And the drop in loan limits should be phased in gradually so there is time for private capital to grow its footprint in higher-value markets. But the time for the transition to normalcy in loan limits is here. What is more, all signs suggest that the Administration and Congress could agree on a reasonable plan to lower limits prudently without delaying broader FHA legislation.

Risk-Sharing

One change to the FHA that has been suggested from time to time is risk-sharing. In 2002, reflecting on efforts of the Clinton administration to pilot single-family risk-sharing for FHA, I wrote a lengthy report as a consultant to the Millennial Housing Commission on the potential benefits and dangers of risk-sharing to FHA's financial health and public purposes.[13]

My thinking today on this topic remains the same: done properly, risk-sharing can be a useful *supplemental* tool to help FHA to better accomplish its mission and find ways to provide credit enhancement in a more cost effective manner. **However, it would be counterproductive to make risk-sharing mandatory for the entire FHA book of business going forward. Such a broad-brush approach runs the risk of "*privatizing profits while socializing losses*" and would impair FHA's ability to serve underserved borrowers and provide countercyclical credit in times of market stress.**

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[9] Ibid, 14: Exhibit II-3.
[10] Ibid, 15: Exhibit II-5.
[11] http://portal.hud.gov/hudportal/documents/huddoc?id=ar2012_forward_loans.pdf Page 46 Exhibit IV-5
[12] Ibid Page 48 Exhibit IV-6
[13] Sarah Rosen Wartell, "Single-Family Risksharing: An Evaluation of Its Potential as a Tool for FHA," June 2002, available at http://govinfo.library.unt.edu/mhc/papers.html.

Risk-sharing means different things with different partners. Sharing risk **with the originator or servicer** could be a way of aligning incentives and improving the underwriting and servicing of the mortgage. Similarly, risk-sharing **with a private mortgage insurer** may improve underwriting to the extent that the mortgage insurer provides a second set of eyes. Nonetheless, alignment of incentives and a second set of eyes are not a substitute for FHA having good risk management practices—that is, knowing itself what risks it is taking, tracking those risks over time, and taking quick action before risks elevate to unacceptable levels.

Risk-sharing of either kind could raise the cost of the mortgage, as private investors will demand a market rate of return. In normal times, this cost may well be worthwhile with the improvement in underwriting and servicing more than offsetting the costs. In times such as those we have recently experienced, where private capital has stood on the sidelines in the parts of the market served by FHA, risk-sharing will significantly raise the cost and, more importantly, limit the availability of credit. Therefore, if risk-sharing is to be used, it should be discretionary with the amount of risk-sharing determined by such factors as the price and willingness of the private parties to bear risk and align incentives. Mandating risk-share formulas in statute would make it difficult to make adjustments to better protect the taxpayer and ensure access to credit continues in times of stress.

In 2002, I offered views on a potential risk-sharing initiative **with one of the government-sponsored enterprises**. In today's environment, with the GSEs in conservatorship, that approach no longer makes sense. However, it is possible that a shared risk initiative might make sense between FHA and a new MBS-level (rather than loan-level) credit insurer in a future housing finance system.

Another idea for single-family risk-sharing would involve sharing risk **with high-performing state and local HFAs**. In 2002, I explored the option at some length:

> As risksharing partners, HFAs bring certain key advantages. They share FHA's commitment to public purposes and accountability to the public. They know the affordable housing needs of their communities far better than FHA can from afar. Some are engines of innovation in designing products to meet local needs. They have delivery systems in place, through non-profit and for-profit lenders that originate MRB loans, some of which reach pretty far into underserved communities. Some HFAs also bring sophisticated analytical and operational capacities, although some rely more on their partners for those skills.....
>
> It is easiest to envision how FHA might share risk with state-sponsored mortgage insurance funds – HFA-affiliated operations that provide mortgage insurance, much like FHA. Only a limited number of states have their own insurance funds, but they include a number of large states like California and New York where, for various reasons including high house prices, FHA utilization is limited. However, if a viable model for risksharing with state insurance funds were to emerge, other states might be enticed to create their own state insurance funds to share risk with FHA.[14]

While risk-sharing could reduce the exposure of FHA to mortgage credit risk, it would necessarily increase FHA's or GNMA's exposure to counterparty risk. If the counterparty such as the mortgage insurer or servicer fails and cannot make good on its contractual obligations, the government is still on the hook, as FHA mortgages are securitized by GNMA and carry a full

[14] Ibid, at pp. 88-91.

faith and credit guarantee. And loans not eligible for GNMA would not likely find significant capital. Therefore, any risk-sharing arrangement would require that FHA or GNMA monitor the credit worthiness of the counterparties.

In addition to counterparty risk, having another party involved in absorbing the loss could create conflicting interests over loss mitigation strategies that must managed. Given current issues facing FHA, it would take time and resources to build capabilities around monitoring and managing counterparties. **I recommend that any risk-sharing start small and be kept simple as these capabilities are built.** More generally, the following principles I recommended in 2002 are relevant to guiding any new risk-sharing initiative.

1. **Incrementalism.** FHA must assess its weaknesses and design new products to meet emerging needs, but it should not try to substitute new wholesale products for existing retail products overnight. It should review new products to see if the markets served and performance match expectations. Meanwhile, it should continue to make available its existing products, unless and until it is clear that the needs served today are being better served by alternatives and would continue to do so under different market conditions.

2. **Experimentation.** FHA should test and pilot new approaches. It should try a range of different financial structures, types of partners, types of products, and target markets and learn what works and what does not.

3. **Defining Broad Goals and Providing Programmatic Flexibility.** Policymakers should resist the temptation to prescribe the specific business terms of risksharing agreements (formulas for sharing risk and premium, allocation of responsibilities, oversight mechanisms, etc.) in legislation. Instead, they should establish goals, identify performance measures, and hold FHA accountable for achieving those goals. In return, they should give FHA the flexibility to undertake different approaches to meet those goals and authority to expand those that work and drop those that fail to meet public purposes.

4. **Providing FHA Internal Analytic Capacity.** FHA cannot rely upon a risksharing partner to protect FHA's financial interest and public purposes. For itself, FHA must design and assess agreements against FHA's goals, manage counterparty risk, and analyze the risk it is incurring from the risksharing business and see that it matches the program targets. FHA needs staff with the capacity to undertake these analyses, in consultation with contractors and advisors. FHA needs new employees with sophisticated financial market expertise and skills. Moreover, FHA needs the authority to quickly procure financial advisory services to support FHA in the design, implementation, and monitoring of risksharing agreements and risksharing partners....Congress should make it a condition of risksharing authority that FHA acquires contractor and staff resources for this purpose and Congress should provide it with the authority and financial resources to do so.

5. **Enhancing FHA's Bargaining Power through Competition.** One way for FHA to find partnerships that maximize FHA's objectives is to create competition between potential partners. In some cases, it may make sense for FHA to pilot an approach with a single partner without competition, but, in other cases, partners may be asked to compete for the business opportunity. Statutory language authorizing risksharing should allow FHA to select partners using a variety of mechanisms.

Conclusion

Mr. Chairman, Ranking Member Capuano, and members of the Committee, it is clear that the health of FHA's MMI Fund has suffered because of losses resulting in part from problematic products and processes. Of course, rapidly falling house values due to a persistent economic recession and deep foreclosure crisis were the driving factor. Many of FHA's losses were

inevitable—resulting from FHA's critical role of ensuring credit flow and availability during recessionary periods. However, it is also clear that better analytic capacity and management tools and the capacity to move more quickly to protect the taxpayer from losses would improve FHA's ability to manage, price, and mitigate risk and, ultimately, to protect the Fund.

FHA has taken important steps to stem losses where possible in outstanding books of business and to prevent insuring loans that are too high-risk going forward. They seek additional important authorities that would further strengthen the Fund, and I urge Congress to provide them those authorities quickly. But those steps, to my mind, do not seem to fundamentally change the capacity of FHA to act quickly in the taxpayer's interest, and so I urge Congress to go beyond the revised measures discussed above in the FHA Emergency Financial Solvency Act to the proposals I first discussed above. Clear goals established by Congress, greater data transparency, and more authority to respond rapidly to changing conditions and new insights in order to manage and mitigate risk would go a long way to strengthening the Fund going forward and ensure that FHA does not again become so perilously close to requiring taxpayer support.

At the same time, I urge the Congress to consider FHA's larger role in the housing finance system only in the context of broader questions about the shape of the housing finance market after the end of the conservatorship of the GSEs. We must not take steps now, absent those larger discussions, that would make it impossible for FHA to continue to play its indispensable countercyclical role and its ever-important mission of ensuring credit is available to worthy borrowers who have limited options in the private market.

Small risk-sharing pilots, operated under the principles I articulated above, are possible in the meantime, once FHA has stabilized the insurance fund and is rebuilding its capital reserves, as a way to explore future roles. But, Congress must not let the opportunity pass to strengthen FHA's risk-management capacities immediately. Whatever role is assigned to FHA in the long term, we all will be better served if it has the capacity to manage better the risk it takes on in fulfilling that mission.

Thank you.

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