THE FUTURE OF THE FEDERAL HOUSING ADMINISTRATION'S CAPITAL RESERVES: ASSUMPTIONS, PREDICTIONS, AND IMPLICATIONS FOR HOMEBUYERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
HOUSING AND COMMUNITY OPPORTUNITY

OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE FUTURE OF THE FEDERAL HOUSING ADMINISTRATION'S CAPITAL RESERVES: ASSUMPTIONS, PREDICTIONS, AND IMPLICATIONS FOR HOMEBUYERS

Thursday, October 8, 2009

U.S. House of Representatives,
Subcommittee on Housing and
Community Opportunity,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Maxine Waters [chairwoman of the subcommittee] presiding.

Members present: Representatives Waters, Green; Capito, Miller of California, and Lee.

Also present: Representative Garrett.

Chairwoman Waters. This hearing of the Subcommittee on Housing and Community Opportunity will come to order.

Good afternoon, ladies and gentlemen. I would like to thank the ranking member and other members of the Subcommittee on Housing and Community Opportunity for joining me today for this hearing on, "The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions, and Implications for Homebuyers."

Before I begin, I would like to note that, without objection, Representative Scott Garrett will be considered a member of the subcommittee for the duration of this hearing. Without objection, it is so ordered.

The Federal Housing Administration was created during our last major housing crisis, the Great Depression. At that time, 50 percent of mortgages were in default or foreclosure. Today, we face a housing crisis that is perhaps less severe, but still considerably grave for millions of American families facing foreclosure or trying to buy a home.

Markets have contracted, and homebuyers have limited options when trying to get a mortgage. As a result, FHA has stepped into the void left by the private market. Today FHA is increasingly the only option for most potential American homebuyers, those who don't have 20 percent for a downpayment. While FHA market share was around 3 percent of lending activity dollar volume as of 2006, it has increased to nearly 30 percent of all mortgages originated today. With this drastic increase in market share, we must continue to maintain the integrity of FHA mortgage insurance programs.

I have long been committed to ensuring that FHA remains an available, affordable, and safe option for all families. I wrote legislation ensuring that FHA could provide an alternative to subprime lenders, the Expanding American Homeownership Act of 2007, which was ultimately included in the Housing and Economic Recovery Act of 2008. Also, in May, the President signed the Helping Families Save Their Homes Act of 2009, which included a provision I authored to ensure that FHA programs remained out of bounds for the worst predatory lenders who created our mortgage crisis.

It is a myth that the FHA is the new subprime and has adopted lower underwriting standards and other worse abuses of the subprime market; in fact, just the opposite is true. A recent Federal Reserve report indicates that over 60 percent of the increase in FHA purchase activity between 2007 and 2008 was to borrowers with prime-quality FICO scores. Additionally, the percentage of loans in FHA's portfolio with loan-to-value ratios above 95 percent has fallen from 72 percent in 2007 to 67 percent in 2008. And unlike the subprime market, all of FHA's mortgages require full documentation and verification of the borrower's income and assets.

Let us be clear: Without FHA, there would be no mortgage market right now. Private mortgage insurance companies have raised prices and tightened standards to a level that leaves out many potential homebuyers. With 30 percent of the overall market and nearly 80 percent of the first-time homebuyer market, the FHA is a crucial tool for ensuring a housing recovery.

I am eager to hear from Commissioner Stevens about the steps he has taken to ensure the long-term future of the FHA. I understand the concerns that have been raised regarding reports that the FHA's capital reserve ratio will fall below the 2 percent threshold mandated by Congress. Though we do not know yet the exact level of the capital reserve ratio for Fiscal Year 2009, we know that the economic downturn has affected FHA. I am also interested to hear our witnesses comment on how overall economic conditions will continue to affect FHA, and how industry groups are responding to FHA's increased market share.

I look forward to hearing the testimony of today's witnesses.

And now, I would like to recognize our subcommittee's ranking member to make an opening statement. Mrs. Capito.

Mrs. CAPITO. Thank you, Madam Chairwoman. Thank you for holding this hearing today on recent reports considering the financial health of the Federal Housing Administration.

The financial stability of the FHA program is a key factor to reviving the housing market and to our economic recovery. Since the subprime collapse, the FHA has emerged as the major mortgage market participant. In fact, as the chairwoman has stated, FHA insures 23 percent of all new single-family mortgage loans this year and currently backs a total of 5.2 million home loans.

As we wait for the private securitization market to recover, prospective homeowners and specifically first-time homebuyers have come to relay on the FHA program as a source of mortgage credit.

Last month, on September 18th, FHA Commissioner David Stevens, our witness here, announced that an upcoming actuarial study of the health of the FHA would show the Mutual Mortgage Insurance Fund's capital reserve ratio will drop below the congressionally mandated threshold of 2 percent. At the same time, Commissioner Stevens was quick to assure us that the FHA Insurance Fund has ample reserves to cover future losses and will not require a taxpayer bailout. And I am certain we will hear more about that as we move through the hearing.

I am encouraged that HUD has announced several key changes designed to enhance its ability to manage risk, and specifically the decision to hire a chief risk officer—probably way overdue, in your opinion.

While these recently announced measures are important steps, I continue to be concerned about the FHA's viability and its ability to administer the program in a safe and sound manner. Much has been said and written about the need for the FHA to upgrade its technology and staff. With the significant increase in the FHA's book of business, modern technology and highly skilled staff are fundamental to the future viability of the program, and I look forward to hearing today about the steps being taken to bring FHA into the 21st Century.

I would like to commend Congressmen Lee and Adler on their bill, H.R. 3146, the 21st Century FHA Housing Act of 2009, designed to provide the HUD Secretary with the flexibility to hire new employees necessary to ensure the FHA is run in a manner that ensures its financial stability. This legislation also includes provisions designed to target fraud and abuse within the FHA system.

As FHA's market share has grown, more bad actors have attempted to gain entry into the program. Originators with poor underwriting standards or who have engaged in mortgage fraud should not be FHA-approved mortgagees. The FHA must improve its monitoring of mortgagees to make sure that all FHA-approved lenders are conforming to the program's underwriting standards.

I am anxious to hear from Commissioner Stevens what steps the Department is taking to root out fraud and abuse in the system. Are the current FHA matrix appropriate for the current markets?

We have all heard about these mortgages where not even the first payment has been made. Does FHA monitor first payment default rates? If so, what statistics do you have on these defaults? And what recourse do you have with the lender that makes such a loan?

In late 2007, FHA issued regulations to implement a risk-based pricing program, yet Congress implemented a moratorium through the HERA legislation, which initially prevents HUD from implementing any risk-based pricing through October 31, 2009. Does HUD intend to implement a risk-based pricing program once the moratorium expires? If not, then why not?

Finally, perhaps the Commissioner could give us an update on the seller-funded downpayment book of business. These loans have been banned at HUD's request because HUD said that these loans were problematic and causing a drain on the fund. How much of a drain on the fund have these loans been, and when will their impact begin to diminish?

I want to welcome Commissioner Stevens back to our subcommittee. The FHA program is important, and Congress and HUD need to do whatever is necessary to make sure these programs run in a manner that does not expose the taxpayer to yet another bailout. I look forward to hearing from all of our witnesses today on how best to ensure the future viability of the FHA program.

Again, I would like to thank the chairwoman for holding this hearing, and I look forward to hearing from our panels. Thank you.

Chairwoman WATERS. Thank you very much.

Mr. Green is recognized for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman. And, Madam Chairwoman, I thank you for the work that you have done to not only help people acquire affordable housing, but also to maintain the affordable housing that they may acquire. It has been a labor of love for you, and you have worked to make sure that people are qualified for the housing that they ultimately acquire. And that, I think, speaks well for your work in Congress.

Commissioner, I thank you for being here today. I am eager to hear your testimony as well. If I don't hear it all here, I will hear it from someplace. I will have to leave at some point.

I, too, as was indicated by the Chair, am appreciative of what the FHA has done because it has been an alternative to the subprime market, which means that it has been an alternative to teaser rates, it has been an alternative to prepayment penalties, it has been an alternative to 3/27s and 2/28s. It has been a means by which persons did not have to subject themselves to yield-spread premiums that they were not aware of. FHA has been a straightforward, fair process.

I was saddened to see that the ratio may drop below the 2 percent threshold mandated, but by the same token, I have read where you have indicated that we still have $30 billion in reserves, and that $30 billion will take us through the next several years wherein the crisis that we are having to cope with may at some point bottom, and we may find ourselves on an upswing.

But I do look forward to your testimony, and I am a fan and supporter of FHA. It has been an option for some, but for many it was the only fair option alternative, if you will, to the subprime market that was so devastating to so many people who actually qualified for better loans than they received.

I yield back the balance of my time.

Chairwoman WATERS. Thank you very much.

Mr. Miller is recognized for 5 minutes.

Mr. MILLER OF CALIFORNIA. Commissioner Stevens, welcome. It is good to see you again today; we talked yesterday.

I will say what a difference a day makes. I look back, and between 2000 and 2005 in my district, FHA loans dropped by 99 percent. They were just worse than finding hens' teeth at that point in time. Nobody had them. The reason was the rates that you could loan were so low that you couldn't be active in a high-cost area. And in about 2000, I started working to raise conforming loan limits in high-cost areas and FHA loan limits, because it seemed like high-cost areas were discriminated against. We only had one type of loan available. The GSEs really couldn't compete. FHA was just nonexistent.

I know we have gone through turmoil in recent years, FHA went through some problems, but not unlike the reverse mortgage industry did. The GSE loans had trouble, home equity loans had trouble. And you have made a real gallant effort to revamp these areas and take the problems out that existed, such as subprime. Defining subprime versus predatory was something that was talked about for the last 8 or 9 years; we could never get any traction in doing that. Recently, people realized that has to be dealt with, and I think you have done an effective job dealing with that.

And it seems like you have restructured FHA. You have looked at the appraisal problems you had in the past. You have looked at the underwriting problems, default codes. You have gone through it, and I think you have done an excellent job determining how to make FHA profitable and viable in the future, and I think you are probably going to explain that today. But I think many people don't realize what you have made changes on, the problem areas, and that FHA is probably going to be profitable in the last year's loans you have made, which would put you in a different situation than many think you are in.

But we have had tremendous problems in this country in the housing industry, and if it weren't for GSEs and FHA—for example, you are making about 95 percent of all the loans in the marketplace. I don't think many people who are buying houses and selling houses today, when they go through Bank of America or Wells Fargo, realize that their loan is ending up with Freddie Mac and Fannie Mae, and the FHA is involved in so many areas that people think it is what it used to be, and it is not. If it wasn't for FHA and GSEs, there would be no housing market today, in my opinion.

People are in a very difficult situation. People who own homes have lost tremendous amounts of equity. People who want to buy homes are at a point where they can finally afford to buy a home. But if it wasn't for the work you are doing in the marketplace and the GSEs, those opportunities would never be available. I can't imagine what level housing prices would be today if you weren't serving the people you are serving, because when you have far too many homes on the market, and there are just no loans available, the value of homes just continues to drop.

I have never seen a time in the years I have been in the development industry—over 35 years—where banks didn't want to lend money and banks didn't want deposits. For a bank to take a private deposit from an individual, if it is a large amount of money, it is a liability. It seems like banks today are just holding on to liquidity, concerned about what is going to happen in the future in further foreclosures and what is going to happen in the commercial industrial foreclosure sector.

So I applaud you for being aggressive in the marketplace. I think you are being very prudent in what you are doing. When I say aggressive, I don't mean aggressive in a risky fashion; I think you have been very cautious. You have looked at the situation and you say, what were our problems in the past, and let us look to the future.

I think the $8,000 tax credit helped tremendously. And we talked yesterday about looking at the Down Payment Assistance Program that the private sector has had in the past and saying let us find the problems that have existed in the past in that area, and let us rectify those, get the bad players out. And let us look to the future; how can we do this in a way to create more opportunity and continued opportunity for people who need the assistance of a downpayment, yet knowing that we are making loans to people who can repay those loans, that underwriting standards are consistent with what FHA does. And I applaud you in your willingness to look in that direction.

When you met with us, none of us wanted to do anything that was inappropriate, nor anything that would put the government and the FHA at risk. I think we all understood that. And I think, working together, we can come up with some guidelines and parameters that will work and be viable. I look forward to doing that, and I look forward to your testimony.

Thank you, and I yield back.

Chairwoman WATERS. Thank you very much, Mr. Miller.

I am pleased to welcome our first distinguished guest for our first panel. Our first witness will be the Honorable David Stevens, Assistant Secretary for Housing, and Federal Housing Administration Commissioner, U.S. Department of Housing and Urban Development.

STATEMENT OF THE HONORABLE DAVID H. STEVENS, ASSISTANT SECRETARY FOR HOUSING/FHA COMMISSIONER, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Mr. STEVENS. Thank you, Chairwoman Waters, Ranking Member Capito, and members of the subcommittee. Thank you for the opportunity to testify on behalf of the Federal Housing Administration to talk about the capital reserve ratio.

As you know, the FHA is playing a critical role in the housing market and our economy right now, insuring one-third of all home-purchase mortgages, and 80 percent of its purchase loans are for first-home homebuyers. But as you know, FHA recently announced that our independent, nongovernmental actuarial review is expected to predict that FHA's capital reserve will fall below 2 percent.

There has been considerable confusion about what this announcement means for FHA's overall health, whether this means the taxpayer will bear any responsibility going forward. And so I welcome this opportunity to clarify our situation and discuss the proactive steps being taken to ensure that FHA remains financially sound so that we can continue to support and revive our housing market.

Let me simply state at the outset that based on current projections, absent any catastrophic further home price decline, FHA will not need to ask Congress and the American taxpayer for extraordinary assistance. We will not need a bailout.

FHA has two reserve accounts, which combined currently hold a record level of more than $30 billion in cash reserves, which is more than 4.4 percent of our insurance in force. FHA holds reserves for projected losses over the next 30 years. This is far more conservative than international standards for banks or other financial institutions.

The capital reserve account is a surplus reserve account that holds cash reserves in excess of the cash reserves held in our financing account, FHA's primary reserve account. The FHA financing account is required to hold reserves for losses projected over a full 30-year period. Excess funds above and beyond that are held in a capital reserve account. This is somewhat analogous to a checking and savings account scenario. The financing account, or checking account, holds reserves to pay default claims and losses and receives any payments from premiums, while the capital reserve, the savings account, holds surplus cash.

So why is the capital reserve ratio predicted to fall below 2 percent? That is because the capital reserve ratio only measures how much capital is in that secondary reserve account. In light of the severe decline in home prices, overall performance of the economy, and future housing price projections, FHA expects higher net losses than previously estimated on outstanding loan guarantees over the next 30 years. As a result, surplus funds will be transferred from the capital reserve account to the financing account. That change will drive that secondary account ratio down below 2 percent. However, there will still be substantial funds remaining in the capital reserve account over and above the necessary reserves held in the financing account to meet future expected losses.

This is not a semantic point. While these funds were transferred from the capital reserve account to the financing account, they have not been spent. In fact, even as we experience historically low exceptional conditions in the housing market, FHA still has current reserves of more than $30 billion in its combined financing and capital reserve accounts.

I hope this visual helps, but if you look at the capital reserve, the combined accounts, as of September 30th, the capital reserve portion was well above the 2 percent threshold as of the last report. The financing account held the amount of funds needed to pay forecasted losses based on that independent actuarial review. Now that there has been an updated forecast with future home price declines expected, changes in the discount rate, loss severity differences, etc., money will transfer from the capital reserve account into the financing account, thus putting more money in the financing account to pay expected losses. Less money will remain in the capital reserve account, putting it below that 2 percent threshold requirement. Yet overall the combination of our capital reserve will be higher than it has ever been.

While private mortgage insurers, lenders, Wall Street firms, and the GSEs participated in both owner-occupied and investor-owned markets, they were exposed to exotic mortgages, such as option ARMs, interest-only loans, and some tolerated lax underwriting standards, FHA stuck to the basics during the housing boom: 30-year, fixed-rate, traditional loan programs with standard underwriting.

Indeed, while some have compared FHA's practices to those of Fannie Mae and Freddie Mac, FHA covers a much narrower, more conservative segment of the market. It only insures owner-occupied residences, and has never insured exotic, subprime, Alt-A or "no doc loans." FHA has never wavered from requiring full documentation of employment and income when underwriting for home purchases. This responsible approach has allowed us to limit losses during the economic crisis and fulfill our mission of providing safe opportunities for homeownership to those who can afford a home.

Still, I am committed to ensuring that the agency takes every step possible to provide a clear direction for FHA to address this mortgage crisis. In support of the President and Secretary Donovan's policy and vision to remain financially healthy for the long term, I have already begun to improve portfolio analysis and risk management, tighten our risk controls, and overhaul our targeting and monitoring practices.

We have made more significant credit policy changes in my first 2 months here than FHA has made in decades. We have brought on new leadership with broader and deeper knowledge of skills and a tighter set of risk controls for the agency, recently hiring a new Deputy Assistant Secretary for Single-Family Housing, who started this week, and we are in the process of hiring a Chief Risk Officer to oversee the single-family division that we want devoted solely to managing and mitigating risk to the insurance fund.

With Congress' help, we are working to modernize our information technology systems so that we can develop a set of commonly used fraud-detection tools and fully automated underwriting systems to help us focus our attention on the loan files that are most likely to contain serious deficiencies. I have included more detail on each of these topics in my written testimony, and I would be glad to answer any of those today.

So even as FHA is once again playing a critical countercyclical role in the economy, stepping up to ensure housing markets function where the private sector cannot on its own, as it did during the Great Depression and during the Oil Patch crisis of the 1980's, we are taking nothing for granted. FHA is working aggressively to make sure our reserves reach congressionally mandated levels over projected future losses, and to ensure that we keep affordable, responsible loans flowing, our housing market viable, and our economy on the road to recovery.

Once again, I would like to thank you for the opportunity to participate in today's hearing and for your continued leadership. And with that, I am happy to answer any questions.

[The prepared statement of Assistant Secretary Stevens can be found on page 192 of the appendix.]

Chairwoman WATERS. Well, thank you very much.

I am very pleased that you are here today, and your statement is very clear. And I think that should allay a lot of the fears that seem to have been generated after the initial announcement was made about the level of the capital reserve fund, I believe it is.

I think those of us who have watched FHA and its performance for quite some time now and understand very well that FHA was undermined basically by a lot of the subprime lenders who put those exotic products out into the marketplace that you alluded to, the "no doc" loans, the Alt-A loans, all those exotic products. And people fell into getting into those mortgages, many of whom did not understand what they were doing, and it really undermined the work of FHA. However, since the meltdown, we find that FHA is not only providing those mortgages, but we are all depending on FHA to keep this mortgage market going. And we think that so far a good job is being done, and, as you can see, just judging from the testimony of Mr. Miller, that there is bipartisan support for FHA. And so we are delighted that you are here today.

I don't have any real questions about whether or not you are viable. You said very clearly that you are not coming here asking us for any extraordinary bailout, and that should be made clear. But I do want to ask you about one area that I was interested in and try to correct the problem, and that is this: I discovered some time ago that there were those bad actors out there who, in my estimation, were trying to take advantage of FHA and whom we knew had committed certain atrocities, who continued to come back time and time again. I hope that the amendment that I was able to put forward will stop them and give you the support that is needed at FHA to keep you from having to do business with them. Have you paid attention to this, and what is happening with the bad actors?

Mr. STEVENS. I do appreciate the question. And I very much appreciate your support, particularly our ability to hopefully invest the dollars needed to create fraud-protection tools and have the personnel to support that effort.

Let me just try to articulate what happened as a result of the housing crisis in the mortgage finance system, and how it affected FHA, and how that has transitioned since then.

In the fall of 2007, starting around August, with the beginning of American Home, which ultimately led to the collapses of Lehman and AIG and others in the industry that were engaged in the subprime marketplace particularly, the sudden collapse in the industry affected this loan officer pool which was prevalent across the country originating those kinds of mortgages. And what I saw when I was in the outside world running large financial institutions was a sudden migration almost overnight of what I would describe as rogue players on the margin, who went to the industry to originate any loans that they could originate, many of whom migrated to the FHA program to originate loans that were in the manually underwritten band of the product, which allowed them to do subjective decisionmaking to do those loans. That clearly impacted the books of business in 2007 and 2008, and that performance data is showing up very clearly in today's balance sheet and has a direct impact on this capital environment that we are in today.

A lot has changed since then. First and foremost, most financial institutions started by putting credit score floors onto their book of business. But FHA, as well, saw other things that they were doing to improve that book of business. Most importantly are the changes that we have put into place in recent weeks. In my first 2 weeks on the job, we suspended Taylor, Bean & Whitaker, which had a much lower credit portfolio profile compared to other institutions in our portfolio.

That was an institution I had watched on the outside. And when I came in, we immediately began a deeper investigation, only to find that they had not submitted timely financials and that their behavior was not acceptable to the FHA standards. We suspended them within 24 hours. They had to close their doors, which shows the weakness of that institution.

The changes that I made around capital that we are proposing by rulemaking now that will change the capital standards for the industry will do two things. One, it will eliminate thinly capitalized mortgage participants who should not be in the business and cannot back up representations and warranties. The second thing that changing the capital will do is it will allow our team, which is very qualified but has resource limitations, to focus on the remaining sector of the industry to make sure that their manufacturing loans according to the quality expected of the FHA.

Chairwoman WATERS. I thank you very much. Basically what you are telling us is that the quality of the loans that you are making gives you the confidence that we don't have to worry about extraordinary requests anytime soon.

Mr. STEVENS. Yes. Let me just be very clear. The quality of the 2009 book is very different than the quality of previous books. That is not just in our data or the actuarial data. It is in the HMDA data, it is on the Federal Reserve Board side. Our average credit score is up significantly over previous years, bordering near 690 from about 630. The percentage of our business below 620 FICOs, which are the worst performing loans in the book, has dropped from approximately 50 percent down to about 10 percent. So we are not getting that kind of "tail risk" in the business, as we would call it in the credit risk management world. And the overall data portfolio is very different.

I do want to articulate, however, that I am making certain that we take every step necessary to get the capital level to where it needs to be. These steps that I announced just in the past few weeks, in my opinion, were very clear immediate steps that needed to be taken to make sure that we do things above and beyond what FHA's product quality would naturally do to get the credit characteristics improved. If that is not enough, we will make additional changes.

Chairwoman WATERS. Thank you very much. Mrs. Capito?

Mrs. CAPITO. Thank you. And I applaud you for the changes that you have been making and look forward to more in reaction to the changing market.

I had a couple of questions in my opening statement. I am going to go to the first one. I asked about the risk-based pricing program which is on a moratorium through the end of this month. And I wanted to know what your intentions were to—do you intend to implement the risk-based pricing after the moratorium expires, and why or why not would you be doing that?

Mr. STEVENS. I am going to answer your question this way. First of all, I am well aware of the risk-based pricing, and in my professional opinion, looking at the role that FHA plays in the market, our primary focus and the Secretary's primary focus is to ensure that the housing market gets back on track.

Today as we look at the portfolio, the need for risk-based pricing is not clear and, in our professional view, looking at the credit characteristics and the demographic characteristics of those who need and obtain FHA insurance for their mortgages to buy their home, we believe there could be adverse selection and adverse impact to those who most need FHA the greatest.

So currently I am not planning to implement the risk-based pricing, although we will look at it as we will look at every characteristic associated with risk in the portfolio. And we will address those items as we go forward.

Mrs. CAPITO. So the answer to that is you are going to keep the moratorium on. Do you anticipate that having a hiring of the overall risk officer would have some relationship to whether you move in this direction or not?

Mr. STEVENS. It will absolutely. The risk officer who we are hoping will join FHA is an extremely strong, well-known risk manager in the industry. And this individual will play a role to help be an arbiter, an independent objective advisor, solely focused on credit risk management. When this individual comes in, we will take that data review, how he builds his team, and take that into judgment, without question, in terms of decisions that are made going forward.

Mrs. CAPITO. Let me ask you about the two reserve accounts that you have. You have indicated that FHA has $30 billion in reserves in the capital reserve account. Can you pull your little chart up there? So that is the green part, right?

Mr. STEVENS. Let me just cover them both. The green is the financing account. And it is this account that the 2 percent capital reserve does not apply to on both sides. The capital reserve is measured off of the secondary account, which is really by law stated to be excess reserves above and beyond the reserves that need to be held to pay for forecasted claims.

Mrs. CAPITO. But it is mandated by Congress to stay at the 2 percent or above level, correct?

Mr. STEVENS. That is correct.

Mrs. CAPITO. And the second one, it falls below that because you are scraping the money off to meet what you anticipate future losses may be?

Mr. STEVENS. That is correct.

Mrs. CAPITO. Let me ask you: Where is this money? Is it actually in an account somewhere where you can draw down on it, or is it like the Social Security Trust Fund, just sort of out there?

Mr. STEVENS. The money is held in the Treasury. Is it held in a special account designed solely for this capital reserve?

Mrs. CAPITO. Yes.

Mr. STEVENS. We would have to ask the Treasury how they hold those funds. Here is what I would tell you, and I think it is critical and I have talked about this with other interagencies within the government. This is true excess capital that was generated through the MMI collections at FHA that are held—that are not being applied to losses. Those funds in any financial services standard would be real capital.

So how the Treasury deploys capital: just like a bank. A bank will hold capital reserves. If every individual went to withdraw tomorrow their money from the bank, would the bank have that money in the balance sheet? I cannot answer that question nor can I attest to what the Treasury holds in its reserves today related to obligated funds. But I will tell you that it is real capital and it is real excess reserves, and it is tracked specifically. And in fact, the moves that we take shift money from the capital reserve account to the financing account.

Mrs. CAPITO. So we are still not really sure where it is, though. Let me ask you, then—pull your chart back up there. I want to make sure I understand this. So you are over on the second area right now where it is anticipated you are going to be. How do you anticipate moving that blue line up to the 2 percent if you are anticipating that the losses—that the possible losses that you could incur—we are looking at a market here now where we have rising unemployment, we have people who are defaulting on their mortgages, and I am certain that your default rate and your delinquency rate is up higher, I believe, than it has been.

Mr. STEVENS. Yes.

Mrs. CAPITO. And certainly that is a reflection, I don't think of FHA, but it is just a reflection of the economy in general. How do you anticipate moving that blue line up and at what point—is that years into the future? And how long can that point stay below 2 percent with a congressionally mandated level of 2 percent?

Mr. STEVENS. Right. So the remedy—and we can talk about that maybe secondarily under Cranston-Gonzalez—gives the role of the Secretary to get it back above 2 percent.

But before I go there, let me just answer the real core to your question. The independent actuarial review, although it is not complete because it doesn't have the final fiscal year close September numbers in it, we don't expect it to vary significantly. But the independent actuarial review is going to show that the FHA MMI fund will get back above 2 percent on its own, above 2 percent within the next 2 to 3 years. And the reason for that is the way that the capital will grow is that it will grow because new insurance is coming into the balance sheet at record levels, with credit characteristics that are significantly different than past book years, particularly 2007 and 2008.

And let me just share with you a couple of factors that the actuarial audit took into account when they were coming up with this—when they were looking at the forecast of the fund. They assumed several key dynamics, but I want to share a couple of dynamics. They assumed that claims on the 2007 book of business, ultimate 30-year lifetime claims, would run at 24 percent, more than double the worst year in history, almost. And that the 2004—

Mrs. CAPITO. Claims on full mortgages that are defaulted; am I understanding that correctly?

Mr. STEVENS. That lifetime claims on the 2007 book in total would be 24 percent.

Mrs. CAPITO. So one in every four?

Mr. STEVENS. That is right. Correct. And that its claims on the 2008 book would run at about 20 percent. We will see those numbers may vary slightly based on their final forecast. But it is going to be close to that level that we expect to be in the review.

The second thing it is going to use, it is going to use a forecast received from Global Insight—who I believe is on the next panel—that did a home price appreciation forecast. They will revise—

Mrs. CAPITO. Appreciation?

Mr. STEVENS. Home price forecast.

Mrs. CAPITO. Depreciation or appreciation?

Mr. STEVENS. In this case it is a depreciation forecast. Thank you. This was a significant change over the previous forecast.

A year ago when the audit was completed and provided to Congress, it used Global Insight's forecast, which forecasted that the home price market would bottom out towards the end of this calendar year. In the forecast that is being used for this upcoming audit by our independent auditor, the forecast is based on information from about a month ago which shows that home prices will not bottom out until somewhere in the end of the first quarter of 2009. And home prices will—

Mrs. CAPITO. 2010?

Mr. STEVENS. Home prices will continue to decline approximately—

Mrs. CAPITO. You said 2009.

Mr. STEVENS. Excuse me, 2010. Thank you.

And that home prices will continue to drop approximately 8½ percent from now until then. And so that revision in that home price forecast, which is somewhat conservative based on many other forecasts we are hearing as of late, which I think is a well-founded way to look and evaluate the strength of the fund, that additional forecast is overlaid onto that on top of our claim rate.

The third item that I just want to highlight is what we call recovery rates, or we call it loss severity rates; in other words, the amount you recover when homes go into foreclosure. And the actuarial study is assuming that the recovery rates after foreclosure will also be significantly lower.

So even with that 24 percent claim rate on 2007, 20 percent on 2008, worst home price appreciation and worst recovery rates, it is still forecasted that the capital ratio—it is that number that the audit will say needs to be transferred into the financing account to cover losses.

Mrs. CAPITO. Well, my next question—which I don't have time for another question—was going to be what are you modeling this on, but you already answered that. So thank you very much. Thank you.

Chairwoman WATERS. Thank you very much. Mr. Green.

Mr. GREEN. Thank you, Madam Chairwoman.

Let me start by complimenting you on the risk mitigation efforts that you are endeavoring to put in place. If you would, as briefly as you can, because I have another area that I would like to go into, tell me how this will function with the risk mitigation officer. How will that person function in your scheme of things, the type of access a person will have? And I compliment you because you are taking an affirmative step to do what we are having to mandate in some other areas.

Mr. STEVENS. Thank you. And I appreciate your support of the moves we are making.

I have worked in a variety of financial institutions. I was a senior vice president at Freddie Mac. I was an executive vice president at Wells Fargo. I have never been in a financial institution that hasn't had a chief risk officer. That was the first move I promoted in coming into FHA. And the chief risk officer in FHA will function at an equal level to any direct report I have at the Deputy Assistant Secretary level, and will also be directly involved in risk management discussions with the Secretary and other senior leaders within HUD and any interadministration discussions as we talk about risk management. So this individual will be coming in at a direct report position to me.

This individual will also act as a completely independent organization within FHA. And I will be coming back with requests to create a broader organization under this individual over time to ensure that this organization is resourced to the level needed to appropriately analyze and impact risk management with policy recommendations over time.

Mr. GREEN. Thank you. That may be a vote. If it is, I would like to be fair to my colleagues, so I will be brief with my next question.

The net worth requirements for the mortgagees, I see that you are seeking to make sure that they are properly capitalized. Would you give just a brief explanation of how you plan to perfect this, please?

Mr. STEVENS. Congressman, I appreciate the question. As you know, this is in—this is a rulemaking procedure, so it will go out for public comment. What we have proposed is as follows: that the minimum capital requirements for mortgage lenders will increase to $1 million. That is consistent with how other industry players, including Freddie Mac and Fannie Mae, set capital levels. There is a capital breakdown of tangible versus nontangible capital, which I would be glad to talk about in further discussions.

But we have analyzed the ability to back up representations and warranties made by an institution. In my estimation, a million dollars should be the minimum in today's mortgage industry market with the loan sizes that we experience today in the marketplace. That amount of capital is needed just to back up a limited number of claims that an institution may have to support should they manufacture a loan incorrectly.

Mr. GREEN. You also are moving to do something with the loan correspondence to make sure that they are properly, shall we say, within the system. Can you please explain?

Mr. STEVENS. Correct. Yes. A loan correspondent by definition at FHA is a mortgage broker. Mortgage brokers do not underwrite their loans or fund their loans, particularly do not fund their own mortgages. Those loans are sold on a wholesale basis and underwritten and funded by a wholesale lender, albeit Wells Fargo or Bank of America or whomever is ultimately funding those loans for them. Mortgage brokers act essentially as an extension of a lender. And to that extent, for FHA to be in the position of monitoring institutions that are clients of banks is not a position we should play in a quasi-secondary marketplace in the industry.

Just to put it in perspective, Freddie Mac and Fannie Mae never monitor or approve mortgage brokers. They only approve direct sellers, and it really comes down to resource capacity, and the ability to have those resources be able to inspect that level of institution in the marketplace. There are tens of thousands of mortgage brokerage companies in America. If they had to all be approved by FHA, we would have to come to Congress and ask for a staff of thousands to be able to monitor an industry of this size.

We believe that the net effect will be that well-run, well-managed mortgage brokers, more of them will have access to the FHA program through their sponsoring lender. But it will remove the obligation and risk to the taxpayer and the government to have to monitor these tens of thousands of mortgage brokers who do not actually underwrite or fund their mortgages. So we believe it will be expansive to the marketplace as a net effect. But at the same time, it will control risk and fraud by putting that responsibility on the backs of the institutions that have the capital to back up representations and warranties.

Mr. GREEN. Thank you, Madam Chairwoman. I yield back.

Chairwoman WATERS. Thank you very much. Mr. Miller, before we go to vote, we will hear from you.

Mr. MILLER OF CALIFORNIA. I appreciate your explanation on how your real capital reserves are handled and where they are at. The problem I have is not you, it is us. We have on-line budgeting, which is general fund monies. And we have off-line, which is Social Security, which we can't spend. Then we send it to Treasury, and it becomes a unified budget and we spend it all. So we have probably already spent your reserves. Therefore, if you needed more, we would just write you a check, you would give it back to us, and we would spend it too. So I don't think it matters where we go. In the end, it is the same.

But you talked about increasing capital reserves for loan originators. Is that banks, mortgage brokers and such? How much have you increased? Is that the 5 percent we have talked about?

Mr. STEVENS. In terms of capital reserves, the current standard for FHA is lenders can get an FHA Eagle with as little as $250,000 in capital, of which only 20 percent has to be tangible. So for roughly—

Mr. MILLER OF CALIFORNIA. Even if 5 percent of my loan is—

Mr. STEVENS. We are taking it from $250,000 to a million dollars.

Mr. MILLER OF CALIFORNIA. Okay. We have talked about in the past the $8,000. I kind of consider that a downpayment assistance program, through the government, of giving people $8,000 for first-time home buyers. How successful has that been in the marketplace today?

Mr. STEVENS. The downpayment assistance—excuse me, the tax, not the downpayment assistance.

Mr. MILLER OF CALIFORNIA. Same thing.

Mr. STEVENS. I think it is important to distinguish. The one rule that FHA made as it relates to the tax credit, is this tax credit could not be used for the 3.5 percent minimum downpayment requirement. It can be used for additional funds outside of that.

We think it has had some impact on first-time home buyer access to the market place. I think the exact impact is being measured right now by the Administration and we will see, as we reflect back, the ultimate impact on that program.

Mr. MILLER OF CALIFORNIA. Now, we have increased loan limits in high-cost areas. Has that had any impact on your capital reserves?

Mr. STEVENS. Interestingly, the high-cost limits have not had an impact on capital reserves, but they have had an impact on certain markets. So just to give you a perspective on that, at FHA in our total portfolio, loans over $417,000 are about 2 percent of our portfolio. So very little use of the high-dollar limits has been used.

However in California, for example, 13 percent of the loans are FHA that we are seeing right now. So in high-cost markets, I believe FHA is having a profound impact.

Mr. MILLER OF CALIFORNIA. A positive impact?

Mr. STEVENS. Positive impact.

And to use an example from your State, if you are looking at a $500,000 sales price today, and you are a family who wants to buy a home, they are qualified, they have income, they have good credit. But for lack of a $50,000 downpayment—which would be 10 percent—or a $100,000 downpayment—which would be 20 percent—they can't buy a home and that could retard the recovery of communities. So with about a $20,000 downpayment, they can buy that home through FHA.

And remember, these are fully documented borrowers with jobs and good credit. There is no stated income, nothing but a 30-year fixed rate mortgage in the program.

So we believe that the program in markets such as California and other high-cost markets is having a direct impact. But it is not having a big impact on our portfolio.

Mr. MILLER OF CALIFORNIA. There are some of us who fought on that issue for 8 years to get that to occur, because we really felt there would be a true benefit in these high-cost areas.

What is your opinion on making that permanent? And also the home buyer tax credit, extending it to anybody who wants to buy, rather than just first-time home buyers, but anybody who is buying a home in this marketplace. On those two issues, what would be the current opinion?

Mr. STEVENS. Let me separate them both. And first, the Administration is looking very closely at both of them, and we are working very closely with the data and we talk about it and look at the impact on the markets very carefully, and others who are testifying here today will have their own opinion. We believe that the higher limits have had a direct impact.

And with the absence of capital, on nonconforming loans, we believe there could be an impact if private market capital is not readily available on loan amounts over the traditional conforming loan limits. So we do think at this point it has had an impact and we will look to see what the results are of that extension.

As it relates to the first-time home buyer tax credit, there is a variety of data that we have been looking at, both in our own data, and the National Association of Realtors has published a great deal of data about it. We do know there has been a large number of first-time home buyers. We do know that 80 percent of our purchase transactions within FHA this year are first-time home buyers. So FHA is having a large impact on the first-time home buyer market.

As it relates to specifically the impact of the tax credit and how that would impact the market going forward, that has not been measured to my satisfaction yet.

Mr. MILLER OF CALIFORNIA. My last question is, the changes you made in appraisal standards and underwriting standards, what benefit in the long run do you think those are going to have on the FHA system and GSEs and whatever throughout the marketplace?

Mr. STEVENS. I think it will have a profound impact. I think it is going to be very important. We have the Home Evaluation Code of Conduct, which is a highly contentious rule that has been put out in the industry, primarily by Freddie Mac and Fannie Mae, has done—the most important thing that it did to help the industry was it separated influence in the transaction from a commission earning salesperson to the individual examining that collateral. And to that extent, having that arm's length separation, I will tell you from my professional experience of almost 3 decades in this industry, was a very important move.

Our announcement takes away some of the impacts that people have been most concerned with. One, it clearly states that the use of an AMC, an appraisal management company, is not required. It doesn't prohibit, nor does it require, but it encourages the use and payment to appraisers that is common to the industry and it encourages that—

Mr. MILLER OF CALIFORNIA. I do think we need some clarification, So we need to talk about that. But I thank you for your time.

Chairwoman WATERS. You are certainly welcome. We are going to hear from Mr. Lee. We will be able to finish this panel and we will go take our vote and we will come back and take the second panel. Mr. Lee?

Mr. LEE. I will be very brief, and I appreciate the chance to ask a quick question.

I come from western New York, where we never really had a housing boom to bust, and it is a very conservative area where people are careful with how they spend their money. One of the concerns I hear over and over again is fraud and abuse and what we are trying to do to rein that in. I believe Mrs. Capito had mentioned the fact that myself and John Adler had gone together on a bill, H.R. 3146, to help provide some needed flexibility and support for you to amend some of this or ferret out some of the fraud and abuse. Unfortunately, right now this is languishing in the Senate.

Specifically, what procedures do you currently have in place at the FHA to help identify fraudulent FHA lenders?

Mr. STEVENS. Let me first respond by saying, again, we very much appreciate the support for building fraud tools. And at FHA—what I would strongly articulate for everybody who has concerns about this housing finance system is that without a strong FHA and well-managed FHA, this housing recovery would not be occurring, or any signs of recovery would not be occurring. And first-time home buyers would be literally, I believe, locked out of the market in a broad way, and minorities would be locked out of the market in a broad way. In order for it to remain strong, it must have risk management and fraud tools in place that are state-of-the-art. And today, we have an exceptional group that does counter party risk management. Our Inspector General, as well, does audits.

We work very closely in communicating information back and forth. We review institutions based on data that comes in on a monthly basis through our system, and we act on those institutions. I do believe that support for expanding our technology, our systems, and our personnel is critical to the long-term performance of FHA and particularly critical to ensuring that we have enough resource capacity to weed out fraud in the marketplace.

Mr. LEE. Let me just briefly—because I know we are running out of time. But through that analysis—and you have found now, through analysis, that you have a lender that is less than scrupulous, and we want to remove them, what specific steps are taken, then, to get them out of this program?

Mr. STEVENS. It will depend on the nature of what we uncover with these companies.

I would just like to back up. I think the SAFE Act in tandem with fraud tools is going to be a valuable tool; because what happens is often it is a rogue loan officer working for an institution who may perpetuate the fraud. And when we go after the institution, which we often do, that loan officer can simply walk across the street and start working for another company, without any monitoring.

The SAFE Act, which goes into effect over the next year, will have a direct impact on monitoring those loan officers. I think to that extent it is critical. What we do is we have a mortgagee review board, which I chair. It includes the Inspector General, it includes the General Counsel, and it includes some of the key business participants. And we review those institutions on a frequent basis and we take action against those institutions.

We have done a series of those in my first couple of months here. Taylor, Bean & Whitaker was obviously the big headline news, but there have been many others that we have taken action against.

Mr. LEE. Thank you. With that, I will yield back.

Chairwoman WATERS. Thank you very much. Thank you very much, Commissioner Stevens, for being here today.

As Chair of the Subcommittee on Housing and Community Opportunity, I want you to know I am extremely pleased with what you have done in the short period of time that you have been there. We look forward to working with you. We believe, most of us, that FHA is extremely important for creating opportunities for people who could not otherwise get into the mortgage market, and we know that you will continue to do a good job.

Thank you very much, and we are going to go and take a vote now and we will call on the next panel when we come back. Thank you.

Mr. STEVENS. Thank you.

[recess]

Chairwoman WATERS. We will resume our hearing in this Subcommittee on Housing and Community Opportunity. And we will call up our second panel. I would like to welcome our distinguished second panel.

Our first witness will be Mr. Patrick Newport, U.S. economist, IHS Global Insight.

Our second witness will be Mr. Edward Pinto, real estate financial services consultant.

Our third witness will be Mr. Boyd Campbell, member of the executive committee of the Maryland Association of Realtors, on behalf of the National Association of Realtors.

Our fourth witness will be Mr. David Kittle, chairman, Mortgage Bankers Association.

Our fifth witness will be Mr. John L. Councilman, Federal Housing Committee chair, National Association of Mortgage Brokers.

Our sixth witness will be Mr. Peter Bell, president of National Reverse Mortgage Lenders Association.

And our seventh witness will be Ms. Teresa Bryce, president, Radian Guaranty, Incorporated, on behalf of the Mortgage Insurance Companies of America.

Without objection, your written statements will be made a part of the record. You will now be recognized for a 5-minute summary of your testimony, starting with our first witness, Mr. Patrick Newport.

STATEMENT OF PATRICK NEWPORT, U.S. ECONOMIST, DIRECTOR OF MACROECONOMIC FORECASTING, IHS GLOBAL INSIGHT

Mr. NEWPORT. Thank you. My presentation includes charts that are on the last page of the handout.

My name is Patrick Newport, and I am the director of long-term forecasting at IHS Global Insight, an economic forecasting and consulting company based in Lexington, Massachusetts. I have been with IHS Global Insight since 1998 and am part of the U.S. Macroeconomic Service where I cover the national housing market. I have a Ph.D. in economics from Harvard University and an undergraduate degree from Louisiana State University. Thank you for inviting to us this hearing.

I have been asked to discuss IHS Global Insight's U.S. housing outlook with a focus on housing crisis and the tax credit for first-time home buyers.

I want to start by discussing housing prices. According to a number of measures, housing prices are stabilizing. They are stabilizing nationally and across most large cities. They are stabilizing across the world. You can see this in the first chart which tracks the Federal Housing Finance Agency's seasonally adjusted, Purchase-Only House Price Index at a monthly interval.

Over the period from 2000 through 2006, inflation-adjusted house prices rose about 33 percent, peaking in March 2006. Since then, real prices have dropped 14 percent and are now 13 percent above their average value in 2000. Nominal housing prices, which are not adjusted for inflation, rose 63 percent over the same period of 2006 and have dropped about 11 percent from their peak. The FHFA House Price Index bottomed out in April 2009 and has risen now for 3 straight months.

A second measure of house prices, the Case-Shiller House Price Index, is showing a similar pattern. In July, seasonally-adjusted prices increased in 17 of the 20 cities that Case-Shiller covers. Nine cities saw prices rise for the third straight month. Las Vegas was the only city reporting a steep decline. The key reason for this recent stabilization, which I would characterize as occurring much sooner than expected, is the decline in long-term interest rates.

My third chart plots the yield on the 10-year Treasury note, which, as you can see, is near its lowest level since 1960.

The fourth chart tracks long-term fixed mortgage rates, which are also near historical lows. There are more reasons that prices are stabilizing. One is that prices have fallen so far that, by some yardsticks, they are below their long-run equilibrium value.

A third reason is a tax credit for first-time home buyers which has stimulated demand. I would like to briefly discuss this factor because it plays an important role in IHS Global Insight's housing outlook for 2009 and 2010.

According to recent surveys of real estate agents by Campbell surveys, about 1.6 million of the 3.9 million homes sold through mid-September went to first-time home buyers. If one extrapolates these numbers, first-time home buyers will total about 2 million in 2009 and about 400,000 of these, according to the survey's methodology, will be incremental buyers; that is, buyers who would not have bought a home this year without the tax credit. The impact of the tax credit thus is not trivial.

The main effect of the tax credit is to shift demand from 2010 into 2009; therefore, once the tax credit expires, demand will take a hit, home sales will drop, and house prices will resume their downward course, depressed by the weight of rising foreclosures and rising unemployment rates. Our view is that home prices will drop another 5 percent from current levels, hitting bottom in 2010.

My fifth chart is the forecast for home sales. As you can see, the pace has accelerated since bottoming out in the first quarter of this year, and we expect it to reach about a 6 million unit pace in the fourth quarter of 2009. The drop that you see in 2010 is a result of the tax credit expiring. We expect sales to tail off to about 5.5 million in 2010.

Although we don't see bond yields heading substantially higher over the long run, it is too early for a bear market to begin, since we judge the economy as too weak, inflation too distant a threat. Markets appear to have taken this view, and yields are now below 3.5 percent. And we expect them to remain below 4 percent in 2010 and most of 2011.

[The prepared statement of Mr. Newport can be found on page 95 of the appendix.]

Chairwoman WATERS. Thank you. Your time has expired. And we will get back to you with questions.

We will now move to our second witness. That is Mr. Edward pinto, real estate financial services consultant.

STATEMENT OF EDWARD J. PINTO, REAL ESTATE FINANCIAL SERVICES CONSULTANT

Mr. PINTO. Thank you, Chairwoman Waters, Ranking Member Capito. Thank you for the opportunity to testify today.

I have 35 years experience in all facets of housing finance. I am here to advise you of the growing crisis at FHA so that this subcommittee will not be able to say that no one told them.

FHA's annual rate of new foreclosure starts increased from 0.15 percent in 1951, to 2.36 percent in 1998, to an estimated 4.4 percent in 2009. This is a 30-fold increase, an increase that would have been much greater but for the massive recent growth of FHA. This trend will continue as millions of recently insured high-risk loans start foreclosing in greater numbers.

FHA's lending practices negatively impact each and every neighborhood in all of your districts. The reduction in downpayments over the past decades has helped fuel the rising foreclosure rates that have plagued FHA and conventional lending.

Why does FHA appear destined for a taxpayer bailout? Number one, the FHA and the VA now account for over 90 percent of all low-down-payment loans. I have seen dozens of cases where market share expanded into a vacuum created by exiting players, and all ended badly. Two, FHA's dollar volume has exploded and is running 4 times its volume in 2006. Three, FHA's top dollar limit is now $729,000, double last year's limit, and it just was raised in time as the high end of the home market comes under increasing stress.

Yes, FHA's average FICO score has increased from 631 to 672 in the last 2 years, and in August it was even higher at 692. Two notes of caution. August rates of 692 FICO about equals Fannie and Freddie's FICO average of 695 on their combined $400 billion portfolio of low, low-down-payment fixed-rate loans that were owner-occupied, generally full-doc, many of the characteristics that FHA has. This portfolio is performing extremely poorly. Fair Isaac Corporation, producer of FICO scores, reports that a 690 FICO on mortgages originated in October 2008 performs like a 630 FICO in 2005–2007. On a FICO basis, FHA's risk has not improved.

FHA's early warning database shows loan performance is deteriorating. Its early warning default rate has increased by 57 percent since 3 years ago. If volume hadn't grown so rapidly, it would have gone up even more. Its cure rate has dropped from 50 percent 3 years ago to 19 percent today. Last month's changes, such as an increase in lender net worth, are little more than Band-Aids. The issue has moved beyond net worth to FHA's business being concentrated among four "too-big-to-fail" lenders. In August of 2009, Wells Fargo, Bank of America, Chase Home Finance, and Citi Mortgage were responsible for 85 percent of all FHA loans added.

FHA has two reserve funds. You have heard that reported earlier. I estimate that the losses embedded in FHA's $725 billion in single-family risk-in-force at $70 billion. Interestingly, Commissioner Stevens had some of the same numbers I came up with, about a 20 percent loss rate or default rate, and I used a 50 percent loss rate on those, yielding a 10 percent total loss yielding the $70 billion. The premiums charged on FHA loans are something under 5 percent. Therefore, there is a big shortfall.

I don't expect the audit to project the losses I am showing. I believe their assumptions will be overly optimistic both as to the loss mitigation benefits of loan modifications and recent and proposed underwriting changes. In my prepared remarks, I talk about the problems that the loan modification problems that FHA has had, are having, and continue to have, and I believe they are worth your study.

There are four positive changes that would provide more consumer protection, police FHA lenders, and end FHA's nightmare of foreclosures. First, set a minimum downpayment of 10 percent. Second, limit FHA's volume to 5 to 10 percent market share. Third, reduce the dollar limit to a level consistent with the FHA's low-and moderate-income housing mission. And, fourth, require FHA lenders to have skin in the game.

I have also outlined in my prepared remarks a specific program on how to help homebuyers save the requisite 10 percent downpayment over a 5-year plan, and I would ask that you look at that also. Thank you very much.

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

Chairwoman WATERS. Thank you very much.

Mr. Campbell?

STATEMENT OF BOYD CAMPBELL, MEMBER, EXECUTIVE COMMITTEE, MARYLAND ASSOCIATION OF REALTORS; MEMBER, GSE PRESIDENTIAL ADVISORY GROUP, NATIONAL ASSOCIATION OF REALTORS (NAR)

Mr. CAMPBELL. Madam Chairwoman, Ranking Member Capito, and members of the subcommittee, thank you for the opportunity to share our views of the importance of FHA mortgage insurance. My name is Boyd Campbell, and I am a managing partner and associate broker for Century 21 Home Center in Lanham, Maryland. I serve on the Maryland Association of Realtors Executive Committee and as a member of the National Association of Realtors Presidential Advisory Board on Government-Sponsored Enterprises. I have worked extensively with FHA and consumers who would not be able to purchase a home without it. I testify today on behalf of 1.2 million members of the National Association of Realtors.

The Federal Housing Administration is more important than ever to homebuyers. In the wake of a collapsing private mortgage market, FHA has played a critical role removing inventory from the market and stabilizing home prices. For this reason and many more, the strength and solvency of the FHA is a top priority for Realtors who work every day building our Nation's communities. We continue to believe in the financial stability of FHA and think their solid underwriting and prudent policies have helped them withstand the housing collapse.

Although FHA's capital reserves have fallen, it is important to remember that this is not the result of irresponsible lending or high default rates. Instead, it is simply the result of falling housing prices for the loans in their portfolios. The overall reserves of FHA have never been stronger, and their borrowers have higher credit scores and higher equity than ever before.

We support what FHA is doing to make appropriate changes to ensure its continuedviability. Under the leadership of Dave Stevens, FHA is well poised to continue to meet its mission of making available safe, affordable mortgage financing to American families without risk to the taxpayer.

NAR supports several enhancements to the FHA program to ensure that more homeowners can take advantage of their program to purchase affordable properties. First, NAR strongly supports increased funding for FHA to upgrade their technology and the flexibility to hire appropriate staff and expert consultants to work on specific program areas within FHA's operations.

The House recently passed H.R. 3146, the 21st Century FHA Housing Act of 2009, which would upgrade outdated systems and allow flexibility for hiring. We also understand funding for technology has been included in the appropriations bill for HUD. We urge that funding be included in the final version of the fiscal year 2010 appropriation for HUD.

NAR also recommends several changes to FHA's requirements related to condominium purchases, which are the most affordable housing option for purchasers. Specifically we ask that FHA eliminate their owner occupancy requirements, increase or suspend the FHA concentration limit, eliminate the presale requirement, clarify the condo reserve study, and eliminate the spot loan approval process. All of these changes would help consumers with more affordable choices when purchasing a home, would help strengthen our communities, and reduce inventory and stabilize home prices.

Finally, Realtors strongly support making permanent the FHA loan limits that are currently in effect. The current loan limits are set to expire in just a few months, on December 31, 2009. We believe lowering the loan limits will further restrict liquidity and make mortgages more expensive for households nationwide. Committee members Brad Sherman and Gary Miller have introduced a bill, H.R. 2483, that would make the current loan limits permanent. We urge the subcommittee to quickly consider this important legislation.

In addition to strengthening FHA, NAR asks that Congress consider two other courses of action to ensure the housing market recovers. First, Realtors ask that you extend the $8,000 first-time homebuyer tax credit through 2010. NAR's research shows that 350,000 sales this year can be directly attributed to the availability of the credit. Retaining the tax credit will sustain our economic turnaround and build a stronger recovery.

Second, we ask Congress to urge the Obama Administration to quickly implement the new Foreclosure Alternative Program, which would help to promote and improve short sales, giving more families a viable alternative to foreclosure.

The National Association of Realtors believe in the importance of FHA and think it has shown tremendous leadership and strength during the current crises. We believe Congress and the Administration are taking the right steps to facilitate the economic recovery. Now is not the time to pull back. Additional resources are needed to ensure the housing market and our national economy recovers.

Thank you for this opportunity to testify. We stand ready to work with you to accomplish our recommended proposals.

[The prepared statement of Mr. Campbell can be found on page 54 of the appendix.]

Chairwoman WATERS. Thank you very much.

Our fourth witness will be Mr. David Kittle.

STATEMENT OF DAVID G. KITTLE, CMB, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION (MBA)

Mr. KITTLE. Thank you, Chairwoman Waters and Ranking Member Capito. MBA greatly appreciates the continued attention this subcommittee has focused on FHA. We are here today because after withering on the vine for so much of this decade, the FHA is back, and is now insuring upwards of a third of the mortgage market. FHA is serving as a vital source of liquidity during the current downturn, and it was this committee working on a truly bipartisan basis that helped pave the way for FHA's resurgence with the passage of last year's landmark Housing and Economic Recovery Act.

Today, amidst much good news about FHA's renaissance, there is also cause for concern, which is what brings us here this afternoon. FHA's capital reserve ratio has dropped to a dangerous new low, and some are starting to wonder whether taxpayers will be required to step in and, dare I say, bail out FHA. So I think it would be beneficial to first examine why FHA is at a crossroads.

Like the rest of the mortgage finance industry, FHA has not been immune from the economic disruptions that have roiled the entire housing sector. A rapidly rising unemployment rate has led more FHA borrowers to fall behind on their mortgages, while plummeting home prices have resulted in more foreclosures and greater losses on each property. Add to that FHA's mission, which is to help borrowers who are underserved by the markets, those with lower incomes, less than stellar credit, or insufficient downpayments. The result is that 13.7 percent of FHA loans are past due with a foreclosure rate of just under 3 percent. As more loans mature, and if this current trend in employment and home prices are not quickly reversed, we anticipate both of those figures to increase, placing FHA in even greater peril.

So what do we do about it? We can sit back and hope for the best, or we can be proactive and take the necessary steps to build a more solid foundation so FHA can continue to fulfill its important mission of opening doors to affordable homeownership.

MBA has put forward a comprehensive agenda that will build on the important reforms contained in HERA. First, Congress needs to appropriate the funding it authorized under HERA for FHA staffing and technology needs. Allowing FHA to hire additional staff to keep up with its growing loan volume is good management, and it is a step we can take right away. FHA makes money for the Federal Government. It should be allowed to use some of it for staffing and technology needs. And FHA should be permitted to compensate its staff at the same pay scales used by other Federal financial regulators like the FDIC and the SEC.

I want to commend this committee for shepherding through the full House H.R. 3146, the 21st Century FHA Housing Act, which authorizes up to $72 million annually for FHA. We need to redouble our efforts to make certain this money is appropriated. We need to improve the quality of FHA originations. One way to protect the soundness of the FHA is to ensure that the mortgage lenders and mortgage brokers who participate in the program and originate FHA-insured mortgages have the competence and wherewithal to protect consumers and taxpayers from undue loss.

We believe that rigorous licensing and registration requirements as well as net worth minimum bonding requirements are essential components of any protective framework. We continue to support increased net worth and bonding requirements for mortgage bankers and brokers. Net worth requirements serve to assure that an originator has a stake in the industry.

Third, Congress needs to make permanent higher loan limits that would otherwise expire in December. While it may seem counterintuitive at first, higher loan balances actually perform better than those at the lower end of the spectrum. They require higher downpayments and bring in higher premiums, and they are essential to ensuring the availability of financing in many areas of the country where there are no other options.

Chairwoman Waters, I would like to close on a personal note. I have been in the mortgage business and working with FHA-insured loans since 1978. I bought my first house with an FHA mortgage. I have seen the highs, and I have seen the lows, and I have never given up on FHA. MBA members understand the value of FHA, and we are committed to making sure the agency weathers the current downturn. We stand ready to work with this committee as well as the very capable leadership at HUD to take the necessary steps to protect and strengthen its important programs. Thank you.

[The prepared statement of Mr. Kittle can be found on page 85 of the appendix.]

Chairwoman WATERS. Thank you very much.

Mr. Councilman.

STATEMENT OF JOHN L. COUNCILMAN, CMC, CRMS, FHA COMMITTEE CHAIR, NATIONAL ASSOCIATION OF MORTGAGE BROKERS (NAMB)

Mr. COUNCILMAN. Good afternoon, Chairwoman Waters, Ranking Member Capito, and members of the subcommittee. I am John Councilman, the FHA Committee Chair of the National Association of Mortgage Brokers. I am a certified mortgage consultant and certified residential mortgage specialist with over 26 years of experience as a mortgage broker. I would like to thank you for the opportunity to testify today with regard to the future of the Federal Housing Administration's capital reserves.

Before I address our overall concerns, I must first extinguish some false allegations targeted at mortgage brokers. Brokers do not create loan products. We do not underwrite the loan or approve the loan or the borrower. We provide a consumer with a variety of choices, then permit them to choose the loan and loan payments that fit their particular needs. A mortgage broker is an independent origination channel helping consumers purchase or refinance their home in communities large and small, urban and rural, in all 50 States. Mortgage brokers are defined by FHA as correspondents. Typically, mortgage brokers transfer FHA-insured mortgages to sponsoring lenders who underwrite the loan, and then the correspondent and the underwriting lender are responsible for adhering to all FHA regulations and guidelines.

NAMB was the first to call for heightened professional standards and licensing for all mortgage originators. In July 2008, the Safe Act established the very standards we sought. Under the SAFE Act, all State-licensed originators are required to undergo criminal background investigations, submit fingerprints, and meet minimum education and testing standards. This ensures that mortgage originators remain competent, and prevents unqualified individuals from entering or working in the mortgage industry.

We believe FHA rules and policies and recent reforms across the entire mortgage industry will prevent the problems leading to the collapse of the subprime market from creeping into FHA. The new SAFE Act standards, coupled with FHA's monitoring and approval requirements, insulate against that happening. FHA set higher standards than the subprime market. FHA does not permit features such as prepayment penalties, no income verification, sharp payment rises that were prevalent in so many subprime loans, creating higher risk. As a result, FHA loans have performed better than subprime or even Alt-A loans.

Now, FHA Commissioner Stevens has proposed sweeping policy changes to the FHA loan program that greatly impact mortgage brokers. NAMB applauds the Commissioner for the work he has done; however, we do believe there are some issues to be remedied. My written testimony will provide the committee with more detail.

We do recommend updating the Neighborhood Watch Early Warning System, improving the Mortgagee Review Board process, increased funding, permanently establishing increased FHA loan limits at their current levels, and flexible mortgage insurance premiums.

There are two areas of particular concern to NAMB members. A recent mortgagee letter will force FHA lenders to adopt most of the Home Valuation Code of Conduct, the HVCC adopted by Fannie Mae and Freddie Mac. It would prohibit mortgage brokers from ordering appraisals. The HVCC purports to enhance the independence and accuracy of appraisals by effectively turning the appraisal process over to appraisal management companies, AMCs; however, what the HVCC truly accomplishes is a dramatic increase in consumer costs and a decline in appraisal quality, missed closing deadlines, and the virtual extinction of independent appraisers, causing a decline in home values and resulting in a loss of local tax revenue.

We find it unconscionable that consumers are paying more for inaccurate appraisals. Many of the AMCs are owned by major lenders, making appraisals an excellent source of revenue for them whether a loan closes or not. Appraisers are reportedly getting greater pressure from these AMCs than they experienced previously. We urge Congress to quickly pass H.R. 3044, which has 108 cosponsors. That would put the HVCC on hold while developing a better plan. FHA's implementation of the core HVCC by January 1st should be immediately reversed.

Our second area of immediate concern is the plan to eliminate correspondent mortgagees. Originators of FHA loans would no longer be supervised, approved, or monitored by HUD. NAMB agrees that an audit for these mortgagees is not needed; however, originators need full access to the FHA connection, total scorecard, and FHA's industry outreach. NAMB would welcome the opportunity to work with FHA on this process.

Studies show that mortgage brokers are the most efficient mortgage distribution channel. They are vital to the health of FHA, and our members have proposed many of the changes enacted by FHA in recent years.

NAMB appreciates the opportunity to appear before this committee, and we look forward to continuing to work with you and other regulators to craft solutions that face the industry. Thank you. I will be happy to answer any questions you may have.

[The prepared statement of Mr. Councilman can be found on page 69 of the appendix.]

Chairwoman WATERS. Thank you very much.

Mr. Bell?

STATEMENT OF PETER H. BELL, PRESIDENT, NATIONAL REVERSE MORTGAGE LENDERS ASSOCIATION (NRMLA)

Mr. BELL. Madam Chairwoman, and members of the committee, thank you for the opportunity to appear at this hearing to discuss the often misunderstood topic of reverse mortgages.

Today, the reverse mortgage market is comprised almost exclusively of the FHA home equity conversion mortgage, commonly known as the HECM.

The FHA insurance provides important protections and benefits to homeowners. This insurance enables a lender to advance a significantly higher percentage of a home's value than would be available in an uninsured reverse mortgage. Furthermore, the insurance provides an ironclad guarantee that the homeowner will have uninterrupted access to the reverse mortgage funds if anything should occur to disrupt their lender's operations.

Many have questions about the risks that the various parties—borrowers, lenders, and the FHA—are exposed to under the HECM program. For borrowers, risks include primarily taking a HECM loan, but ultimately finding out that they cannot sustain the costs associated with living in the home, particularly taxes and insurance, and then being forced to move out. These risks can be mitigated by having an effective network of competent counselors, and HUD has been working to enhance the counseling that is available to reverse mortgage borrowers.

Risks to lenders exist in a few areas. If a HECM loan is not properly originated, FHA can deny an insurance certificate, leaving the lender with a loan that it is obligated to fund, but which does not have insurance.

The risk to FHA can arise from essentially three factors: loans remaining outstanding beyond their actuarial expectation; higher interest accrual; or a decline of property values.

To manage the program with greater caution, HUD has taken steps to mitigate risk by reducing the funds available to seniors through a reverse mortgage. HUD recently implemented a reduction in what is known as the program's principal limit factors, and this has negated the need for credit subsidy, returning the program to operating on a net-neutral basis.

The HECM program has operated on a self-sustaining basis throughout its duration, requiring no taxpayer subsidy. Income from mortgage insurance premiums has exceeded payouts or claims. In fact, according to a recent Congressional Budget Office presentation on its 2009 credit reestimate, the HECM program has generated a cumulative net gain for FHA of nearly $7 billion since its inception. Accordingly, the HECM program has not played a role in FHA's recent capital reserve account losses.

The question of whether the program will require a positive or negative credit subsidy after 2010 has been raised. With the changes HUD has made, NRMLA believes that the HECM program in years ahead will operate on a break-even-or-better basis. Risk has been mitigated by reducing principal limits. However, it should be noted that this adjustment comes at great cost to some seniors. In some cases the end result is that seniors will not be able to utilize HECM to preserve their ability to continue living in their homes, forcing them to move out.

HUD is also implementing more sophisticated information systems to better monitor HECM program performance and reduce operating costs. If such systems had been in place previously, we believe analysis of the HECM program would have revealed that the $798 million in credit subsidy in OMB's initial projection might not have been warranted. Based on our financial modeling of the program, and consistent with home price appreciation assumptions and reports put out by Global Insights and other key observers, NRMLA feels that to project that subsidy need, one would have to make assumptions about home values in the future that are far more pessimistic than any of the major forecasters.

It is also possible that the anticipated duration of loans could be overstated in OMB's calculations. HECM loan duration averages fewer than 7 years, with very few loans lasting longer. Loans to younger borrowers have durations similar to loans to older borrowers, a counterintuitive outcome. Payoff rates for borrowers who take out loans at age 65 are the same as for borrowers at 75: 65-year-olds tend to terminate their loans when they sell and move out; 75-year-olds tend to terminate their loans after a mortality event.

If expected loan durations are adjusted to reflect actual experience, and future home price assumptions are in line with most of the major forecasters, the program could, in our opinion, continue to be allowed to operate without the principal limit reductions and still not require credit subsidy.

NRMLA supports efforts to keep the program operating on a self-sustaining basis. However, we also believe that there are other options for achieving this objective, changes that would have a less detrimental impact on senior homeowners than reducing the amount of money they get. What we have found in looking at the impact of the principal limit reductions is that over 20 percent of the borrowers in the past year, approximately 23,000 homeowners, would have received loan proceeds that were less than their existing indebtedness as a result of the principal limit reductions. This means that they would not receive enough money from their reverse mortgage to pay off the existing loan on the property, thus they would not be eligible for the HECM, forcing them to sell and move or possibly face foreclosure. An alternative we recommend would be to adjust the mortgage insurance premiums.

[The prepared statement of Mr. Bell can be found on page 38 of the appendix.]

Chairwoman WATERS. Ms. Bryce?

STATEMENT OF TERESA BRYCE, PRESIDENT, RADIAN GUARANTY INC., ON BEHALF OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA (MICA)

Ms. BRYCE. Thank you, Chairwoman Waters and Ranking Member Capito. Also, Congressman Green, it is good to see you again. I enjoyed our recent discussion on the housing industry and mortgage insurance.

I appreciate the opportunity to testify on behalf of the Mortgage Insurance Companies of America. This afternoon, I would like to make three points. First, private mortgage insurance, or MI, plays an important role in stabilizing the current housing market and will play a key role in the market's recovery. MI enables responsible borrowers to buy homes with less than a 20 percent downpayment. Many of these are first-time or lower-income home buyers.

Since 1957, mortgage insurance has helped over 25 million families buy homes throughout the country. Today, about 9 percent of all mortgages held by financial institutions have mortgage insurance. Mortgage insurance is important to the housing recovery. With today's low housing prices and mortgage rates, there is a real opportunity for mortgage insurers to help first-time homebuyers and help homeowners attempting to refinance, and by doing so, we also enable existing homeowners to trade up to purchase a larger home.

I would also note that because mortgage insurance companies have their own capital at risk, we have very clear incentives to mitigate our losses by taking action to help borrowers avoid foreclosure if at all possible. We understand that one of the worst challenges that a family can experience is the loss of their home through foreclosure.

In addition to implementing the government modification programs in the requested timeframes, mortgage insurance companies have implemented a number of programs such as free counseling services and advanced partial claim payments to assist borrowers. Over the last 18 months, mortgage insurers were able to save almost 200,000 people from losing their homes.

My second point is that the industry has the resources to pay claims on existing loans and insure new loans because of the rigorous State-imposed capital and reserve requirements. These requirements have been in place since the industry's inception over 50 years ago and mirror the recommendations made at the recent G–20 summit to reform the mortgage securitization market.

In 2007 and 2008, private mortgage insurers paid over $15 billion in losses and have continued to pay billions of dollars more in 2009. The backbone of the industry's financial strength is its State-Imposed reserve requirements, and specifically the contingency reserve. Half of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for 10 years. This ensures that significant reserves are accumulated during good times to handle claims in bad times. This reserve structure has proven its ability to absorb significant risk. In the regional recessions in the 1980's and 1990's, mortgage insurers paid out over $14 billion in claims. After each recession, we built up capital, and were able to meet the next stress period.

Mortgage insurers and the banks that make the loans face similar mortgage default risk, but only mortgage insurers raise capital in this countercyclical manner. In fact, only now are Federal bank regulators working to construct a similar system for banks.

My third and final point is that several of the features of private mortgage insurance and the way mortgage insurers manage their risk differ from FHA. Congress might want to consider these differences as they consider ways to strengthen FHA. With private mortgage insurance, there is private capital at risk. In a foreclosure situation, mortgage insurers take the first dollar of loss and typically cover 20 to 25 percent of the loan amount. But this does not always cover the entire loss, so lenders and investors are on the hook as well. We continually improve our risk analytics and update our underwriting guidelines to respond to market conditions.

In conclusion, it is important to be clear that, like FHA, mortgage insurance was largely avoided during the boom market when 50 percent or more of loan originations were done with piggyback loans.

I also want to assure this committee that mortgage insures continue to insure new loans, that we have the capital to pay claims on existing loans, and that we are committed to insuring new loans that are both affordable for the borrower at closing and sustainable over the life of the mortgage. Thank you.

[The prepared statement of Ms. Bryce can be found on page 45 of the appendix.]

Chairwoman WATERS. Thank you very much.

I will use another 5 minutes to ask a few questions of our panelists. I really wanted to get to Mr. Pinto. But before I do that, Ms. Bryce, let me ask you if it is true that private mortgage insurers are requiring different downpayments depending on locations? Is this happening?

Ms. BRYCE. That has happened in the past. The focus has been on making sure that loans were sustainable for borrowers. We have moved away from that at this point.

Chairwoman WATERS. Thank you very much.

Mr. Pinto, in your testimony you make the case that FHA loans are tremendously risky, and that the FHA will require a $54 billion bailout. To support your argument, you note that FHA will perform like Fannie Mae's 2006 high loan-to-value book; and in testimony before the Committee on Oversight and Government Reform in December of 2008, you described Fannie Mae's book of business as invested with subprime stated income option, adjustable rates, ARMs, and piggyback loans. But isn't Fannie Mae's high loan-to-value 2000 book of business quite different from the FHA's current book of business?

In contrast to Fannie Mae, FHA insures primarily 30-year fixed-rate loans, all of which are amortizing. FHA requires full documentation in all of its purchase and new refinance transaction. FHA does not allow "no downpayment" or piggyback loans.

So we will just stop with that. How then can you compare the two?

Mr. PINTO. Madam Chairwoman, thank you for the opportunity to clarify that question.

The $400 billion that I used as the proxy excludes all the loans listed by Fannie and Freddie as Alt-A. It excludes loans listed by Fannie and Freddie as the other characteristics, negative amortization, etc. It only included the loans that they list as low-down-payment loans. Ninety-three percent, I believe, are fixed rate. They are all virtually at the regular rate, much like FHA. They were not at super high rates. I believe 94 or 95 percent of them are owner-occupied. I believe that in many respects they are identical to the FHA book of business. In fact, as I pointed out, the average FICO score on this group was 695.

And it was interesting that Commissioner Stevens—and I believe that the subcommittee should really think about what he said. He said that, in 2007, FHA's book is—the actuaries are estimating that 24 percent, or 1 in 4, of their loans that had all these positive characteristics that everyone is talking about will go to default. And he then said in 2008, 20 percent of all of FHA's loans originated in that year will go to default. He didn't talk about 2006. I would estimate it would be somewhere between 16 and 18 percent. You will note that it is coming pretty close to my 20 percent estimate, which is what I got using the Fannie Mae, Freddie Mac numbers.

Chairwoman WATERS. You indicated that the FHA will require $54 billion in a bailout. How did you get to that number?

Mr. PINTO. I got to it basically by computing what I believe the losses will be on their book of business, which as of September 30th of this year, was $725 billion in loans. And then I froze that book of business, which is what the actuaries would be doing, and then I looked for a good proxy for it, which I have described in my testimony and just explained further how it appears to be a good proxy, which has a default rate of 20 percent. That yields $140 billion of loans that would go bad.

I then assumed a 50 percent loss. Commissioner Stevens didn't mention a loss rate, but he did mention it has been going up quite rapidly, and I believe 50 percent is a reasonable number. You have to remember that unlike the private mortgage insurance bids where the loss is broken up into two pieces, the private mortgage insurance piece is usually to the 20 percent or so. And the investor percentage, FHA is responsible for 100 percent of the loss, and that is on loans that have an average LTV again, as I think the chairman mentioned, that is in the 96 percent range, something on that order. And, therefore, a 50 percent loss is reasonable. That yields a $70 billion loss on the book.

I then looked at the premiums that they would be collecting. I generously use 5 percent. I don't believe their premiums on a life-alone basis add up to 5 percent, but I used that. And that would yield a loss something in the order of $35 billion or $40 billion. And then I added on top of that the need for a 2 percent congressionally-mandated capital requirement. And, I might add that the way that the private mortgage insurers do their capital is actually more conservative, I believe, than the way FHA does theirs. So I would also take issue with that.

Chairwoman WATERS. Very interesting. Obviously your testimony is directly opposite of that of our Commissioner.

So, with that, I am going to go to our ranking member, Mrs. Capito.

Mrs. CAPITO. Thank you, Madam Chairwoman.

Your first statement, Mr. Pinto, or at the beginning of your statement you wanted to reassure us that we couldn't say we didn't know if this, in fact, happens. There are a couple of things that have come before this committee about which I wish we could have said the same thing; I wish we hadn't known or had been quicker to act.

I would like to ask the other members of the panel who are working with FHA financing instruments and in the mortgage business if you share the alarm that Mr. Pinto has expressed with us today in terms of the FHA and the financing at the FHA? Does anybody want to make a comment directly on that?

Mr. Kittle?

Mr. KITTLE. I don't have Mr. Pinto's numbers and access to his data. I would only say in my testimony, I will read it again, that we have concern for the book of businesses out there, including what has been originated so far in 2009 and was not tested. And the variable that sits out there now is the continued—I think which we all addressed and mentioned today—the rising unemployment that continues to rise that will affect it and make it much worse. So we do have concerns about what is out there and what is coming.

Mrs. CAPITO. Mr. Newport, in your modeling, do you take in unemployment, rising unemployment as part of your factors when you are coming to your graphics?

Mr. NEWPORT. Definitely. Our view is that the unemployment rate is still rising, but the economy is starting to recover. We had a very strong third quarter. We are still losing jobs. We think the job losses are going to end early next year, and the unemployment rate is going to peak somewhere around 10, 10.1 percent in early 2010. So we are near the worst part of the labor market downturn.

Mrs. CAPITO. So that is incorporated in the numbers that you reflected with us?

Mr. NEWPORT. Yes.

Mrs. CAPITO. Because you mentioned that we are in a recovery. I certainly hope that is the case. But a jobless recovery is not going to help somebody who is trying to pay their mortgage. If they are unemployed, these problems are going to be exacerbated.

Mr. NEWPORT. It will take time for the labor market to get back on track, but the overall economy is starting to grow, and, in fact, the residential construction sector is going to grow at a 20 to 30 percent rate in the third quarter and continue to grow. So the housing is starting to contribute to growth. But the good news is that the recession is behind us, the economy is starting to grow. We are still losing jobs, but eventually growth will help us start adding to job growth.

Mrs. CAPITO. Mr. Kittle, your organization has testified before this committee that the MBA is concerned with the less scrupulous lenders who once specialized in the lucrative subprime market. This is kind of a theme we have had going through our testimony on our committee and turning our attention now to FHA lending, and we are extremely concerned. I know Mr. Lee has a bill out there. But we are extremely concerned about fraud and abuse and unscrupulous lending behaviors.

The FHA—our Commissioner mentioned that he had moved in certain directions to have higher capital requirements for mortgagees who are using FHA. Do you share this concern? Do you see any specific evidence of any mortgage bankers or brokers who want to exploit FHA's market and take advantage of borrowers who they may feel their choices are limited? And do you think that the improvements that he mentioned in his statement will—what kind of desired effect do you think that will have?

Mr. KITTLE. To answer one part of your question, in my testimony we certainly support higher net worth requirements for mortgage bankers and mortgage brokers, licensing requirements. We would like to see preemption, which would really help lower the cost, and have one set of licensing requirements for everybody instead of State by State. We think education requirements are necessary. Clearly when you have, what the term is now out there is "skin in the game," then you take a higher sense of duty to originate the loans properly. So we fully support Mr. Stevens on that effect.

I don't know, to answer specifically to your question, of any specific mortgage bankers or brokers that are manipulating borrowers today, but we do know that mortgage fraud is rampant and has been rampant for years. And MBA has supported a stop mortgage fraud bill for the last 5 or 6 years.

Mrs. CAPITO. And finally, I would like to ask unanimous consent to put the testimony of Dr. Andrew Caplin, a professor of economics at New York University, into the record.

Chairwoman WATERS. Without objection, it is so ordered.

Mrs. CAPITO. Thank you.

Chairwoman WATERS. Mr. Green?

Mr. GREEN. Yes. Thank you. And I thank the witnesses for appearing.

Ms. Bryce, do you have some product that you would like to share with us that might be of help with FHA in terms of mortgage insurance?

Ms. BRYCE. I don't think there is a particular product that we could offer at this time. I think that we have looked at whether there is some help that we could give in terms of the risk analytics. As you heard Commissioner Stevens say, they are starting to focus more of the risk that they are taking and making sure that they have the right underwriting guidelines and credit criteria. And I think in that regard, the mortgage insurers would be more than happy to give our assistance as they evaluate those issues.

Mr. GREEN. And, Mr. Pinto, thank you for your testimony as well. Because your testimony is so far afield from some of the other testimony we have heard, out of fairness to you, I am trying to ascertain whether you are the canary in the coal mine or the person who believes the sky is falling because something falls out of the tree. And that is not to demean you, but in a metaphorical sense, that is what we are trying to ascertain. So how much credence do you give unemployment and falling prices to the foreclosures that we have at FHA?

Mr. PINTO. I appreciate those comments, Mr. Green, and the opportunity to answer your question.

I start from a little different perspective, and I start from the perspective that 25 million loans out of approximately 52 million loans in the United States are nonprime. And prime is a large misnomer in the United States, because Fannie and Freddie define themselves as prime, and so everything they did they basically said was prime. And we now know that 10 million of their 25 million loans were not.

And so I start with the fact that 25 million loans are out there that are nonprime. A small minority, about 25 percent, 30 percent, are what you call subprime, what I call self-denominated subprime. The rest are these high LTV loans, these other loans. So you start with that. And then if you layer unemployment—

Mr. GREEN. Let me just intercede. You start with that, but how much of that are you attributing to FHA?

Mr. PINTO. FHA is a quarter of that. FHA is a quarter of that 25 million. Fannie and Freddie have 10 million.

Mr. GREEN. Let me use other language. You are indicating that 25 percent of the 25 million would be what we will call bad to poor loans that FHA has on its books?

Mr. PINTO. FHA—again, based on the statements by the Commissioner. When you have a 25 percent default rate on the 2007 book and 20 percent in the 2008, that is a bad book of business. It is hard to define it into good and bad; it is just bad, because that is an extraordinarily high default rate. That is up there with subprime fixed rate.

Mr. GREEN. But now how do you conclude that it is just because the loans are bad, when we have prime loans that are defaulting because of the unemployment and because of the decline in house prices? How do you separate that?

Mr. PINTO. Again, I have looked at these 25 million loans which I call nonprime, many of which were subprime, and 80 percent—80 percent of all the losses are in that group.

Mr. GREEN. But it seems to me that you need some empirical evidence with reference to job losses so that you can correlate that to the foreclosures. If you don't add the job losses and know whether it was a job loss or whether it was just a bad loan, how do you distinguish between the two? Then you have to also factor in the declining values, because the declining values also impact whether or not persons stay with their homes.

Mr. PINTO. FHA, as in any mortgage lending, is partly an actuarial business, which is why they do an actuarial study. And higher-risk loans are more susceptible to the impacts of job losses and housing price declines, and that is why the 80-plus percent of all of the foreclosures that are occurring today are within this subgroup of loans that I call nonprime. They have characteristics that make them nonprime. They are high loan to value, impaired credit, etc., and then all the crazy stuff that was done in addition to what I just described. And so that is what makes them susceptible. And so even if you go back to 1998 and you look at how high LTV loans performed then in a very strong market, they were 6 to 7 times more likely to go into default than a traditionally underwritten lower LTV loan.

When everybody is going up in value, yes, a rising tide raises all ships. The problem this country has ended up with is we have 25 million high-risk loans out of 52 million loans. We have never had that situation before. And 80-plus percent of all of the foreclosures are in that high-risk group, and that high-risk group is most susceptible to the impact of job loss and housing price declines. So there is a direct connection, and that is why this is an actuarial business.

Mr. GREEN. Thank you. I yield back.

Chairwoman WATERS. Without objection, I would like to enter into the record a communication from NID Housing Counseling Agency, Oakland, California.

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

I would like to thank all of our panelists for being here and participating today. We certainly appreciated your testimony.

This panel is now dismissed. The meeting is adjourned.

[Whereupon, at 4:30 p.m., the hearing was adjourned.]

A P P E N D I X

October 8, 2009

Testimony of

Peter H. Bell, President
National Reverse Mortgage Lenders Association (NRMLA)

before the

Subcommittee on Housing & Community Opportunity

Thursday, October 8, 2009

Madam Chairwoman and Members of the Subcommittee:

Thank you for the opportunity to appear at this hearing to discuss reverse mortgages.

National Reverse Mortgage Lenders Association represents approximately 600 companies that are either engaged in the business of making reverse mortgages or provide capital or services to companies that do. We do not represent the entire industry. We represent those companies who take their involvement in this sector very seriously and are committed to core values of treating customers fairly and ethically. As a result, our members want to support the policy work, consumer education, ethics, self-enforcement, and professional development programs that NRMLA undertakes to assure an environment where any senior homeowner is able to obtain a reverse mortgage conveniently and fearlessly.

Our members understand that demographics present a vast opportunity. Our product serves many different types of homeowners facing a wide variety of needs. Those needs will surely continue as the population of age-eligible homeowners grows – and as our society comes to grips with the challenges of financing longevity.

While demographics might point to growth, our members recognize that will only occur if consumers believe that reverse mortgage products are safe and fair, and that those who deliver them are trustworthy. That is the underpinning of our association. We are dedicated to maintaining an environment where homeowners can easily access information and assistance on reverse mortgages, meet with counselors and other trusted advisors, make a thoughtful decision whether they want to obtain a reverse mortgage and, if they decide to do so. work with a reputable company.

Testimony of Peter H. Bell, NRMLA
Before the Subcommittee on Housing & Community Opportunity
October 8, 2009

Some of our signature undertakings include:

- As a foundation, our Code of Ethics & Professional Responsibility by which all members agree to abide. The Code focuses on core values of fairness, confidentiality, integrity, competence, diligence and professionalism. It covers detailed items such as advertising, compliance and communications with consumers.

- An Ethics Committee that continually reviews our Code and refines it whenever necessary, promulgates Ethics Advisory Opinions to help the industry better understand our position on matters of importance, and acts decisively on complaints filed by consumers, regulators, counselors and industry participants. Recent Ethic Advisory Opinions have been issued on advertising and lead generation, and several others are in process..

- Educational seminars that routinely focus on issues like understanding seniors' finances; recognizing cognitive impairment; reporting suspicions of elder abuse; understanding Medicaid, Medicare and SSI; and other topics that help our members understand the client base with whom they work and how best to serve its needs.

- An unyielding commitment to counseling, an important core principle for our organization. While counseling by an independent third party is required by statute under the FHA HECM program, we require it of our members in all cases, with all products, even where it is not required by law.

- A professional designation program, under which candidates must meet licensing and professional education requirements, participate in a symposium on ethics issues, undergo a background check, and pass a rigorous exam.

- We are in the process of developing a straightforward, uniform disclosure that will summarize in a succinct, comprehensible format all of the salient facts about a reverse mortgage that a prospective client might be considering, allowing the consumer to easily compare various offers side-by-side. We realize that we already give our customers plenty of papers to review – on some loans asking elderly homeowners with arthritic hands to sign their name as many as 40 times – but the lawmakers, regulators and in-house compliance experts won't let us address that. So, the best we can do is to try to consolidate and summarize what's contained in that thick sheath of papers in a user-friendly document.

Testimony of Peter H. Bell, NRMLA
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October 8, 2009

Today, the reverse mortgage market is comprised, almost exclusively, of the FHA Home Equity Conversion Mortgage, commonly known as the "HECM." A HECM is simply an FHA-insured reverse mortgage, made to a homeowner of at least 62 years of age, by a HUD-approved lender or correspondent.

Under the HECM program, a borrower pays a mortgage insurance premium (MIP) to FHA and, in return, FHA insures the loan. The FHA insurance provides important protections and benefits to both homeowners and lenders.

From the borrower's perspective, the FHA insurance enables a lender to advance a significantly higher percentage of a home's value than would be available in an uninsured reverse mortgage, yielding a larger principal amount to a HECM borrower than could be obtained through a proprietary reverse mortgage. Furthermore, the insurance provides an iron-clad guarantee that the homeowner will have uninterrupted access to the reverse mortgage funds if anything should occur to disrupt a lender's operations.

From the lender's standpoint, the FHA insurance provides the comfort of knowing that if the value of the home at the time of loan termination is less than the balance due, the lender can file a claim with FHA for any shortfall, up to the maximum claim amount. The maximum claim amount is the lesser of the actual value of the house at the time of loan origination or the FHA HECM loan limit, currently $625,500 (until 12/31/09, unless extended by the Congress.)

Many have questions about the risks that the various parties – borrowers, lenders and FHA – are exposed to under the HECM program. I would like to address those.

For borrowers, possible risks include: (1.) being sold a loan that they believe to be a HECM, with all of its features and safeguards, which turns out, in fact, not to be an FHA-insured loan; (2.) taking a HECM loan, but ultimately finding out that they cannot sustain the costs associated with living in the home -- particularly taxes and insurance -- and being forced to move out. These risks can be mitigated by having an effective network of competent counselors and making sure that seniors understand that they must attend counseling with a HUD-certified counselor, if they are getting a HECM. If counseling does not take place, the senior should beware. Furthermore, the counselor should, as part of a routine counseling session under HUD's new protocols, review with the client their sources of income, assets and recurring expenses to help determine if they could afford to sustain themselves in the home after the reverse mortgage.

Risks to a lender exist in a few areas. If a HECM loan is not originated properly, FHA can deny issuance of an insurance certificate, leaving the lender with a loan that it is obligated to fund, but which does not have insurance. A lender would not be able to sell that loan to an investor and would thus be forced to hold it in its portfolio for its entire duration. When lenders are forced to hold loans in their portfolios, it can have adverse impacts on their capital position, as well as significantly increase costs to service such loans.

Another area of risk exists under the rules for "assignment" of loans to FHA. An important feature of the HECM program, designed to provide liquidity to lenders, allows the lender the option of assigning a loan to FHA when its outstanding balance reaches 98% of the maximum claim amount. However, if a borrower is in arrears in real estate taxes or insurance at that time, HUD will not accept the assignment. If a loan had been placed into a GNMA guaranteed security and was not acceptable for assignment, the lender would have to buy the loan back out of the pool.

Risks to the FHA fund can arise from essentially three factors: (1.) loans remaining outstanding beyond their actuarial expectation, (2.) higher interest accrual due to rates rising over the expected rate and remaining there for a prolonged duration of time, or (3.) a prolonged or deep decline in property values. It typically would take a confluence of at least two of these factors for any particular loan to experience a loss, or a severe change in one of the factors. While this might occur on any particular loan, the likelihood of it occurring across the HECM portfolio is extremely remote.

To manage the HECM program with greater caution during the current downturn in property values, HUD has taken steps to mitigate risk by reducing the funds available to seniors through a HECM reverse mortgage. HUD's recently implemented reduction in the program's principal limit factors has negated the need for credit subsidy as initially requested in the President's proposed FY 2010 budget, returning the program to operating on a net neutral basis.

The HECM program has operated on a self-sustaining basis throughout its duration, requiring no taxpayer subsidy. Its income from mortgage insurance premiums and other sources has exceeded pay-outs for claims. In fact, according to a recent Congressional Budget Office (CBO) presentation on its credit re-estimate for 2009, the HECM program has generated a cumulative net gain for FHA of nearly $7 billion since its inception. Accordingly, the HECM program has not played a role in FHA's recent capital reserve account losses.

Until recently, the HECM program was part of the FHA General Insurance Fund, which includes several non-related programs, as well. While HECM itself generated income, other programs in that fund did not, effectively negating the earnings from the HECM program as they offset claims against that fund from other programs. Now, the HECM program falls under the Mutual Mortgage Insurance (MMI) fund, FHA's primary fund for the basic 203(b) "forward" mortgage program.

This has raised the question of whether the HECM program will require a positive or negative credit subsidy after 2010. A "negative credit subsidy" is a good thing and a "positive credit subsidy" would be bad. In other words, a negative credit subsidy means that the program generates income to cover its pay-outs and does not require subsidy. Positive credit subsidy means that subsidy funds must be provided because a program will incur costs beyond its receipts.

With the programmatic changes HUD has made, NRMLA believes that the HECM program in years ahead will operate on a break-even or better basis. Risk has been mitigated by reducing principal limits. As a result, all HECM borrowers will receive a reduced amount of loan proceeds

However, it should be noted that this adjustment to the program comes at a great cost to some seniors. In some cases, the end result is that seniors will not be able to utilize HECMs to preserve their ability to continue living in their homes, forcing them to move out.

The Department is also implementing more sophisticated information systems to better monitor HECM program performance and reduce operating costs. Better systems will enable HUD to gain deeper insight and make continual program adjustments, as necessary.

If such systems had been in place previously, we believe analysis of the HECM program would have revealed that the $798 million in credit subsidy in OMB's initial projection might not have been warranted. Based on our financial modeling of the program, NRMLA feels that to project that deep a subsidy need, one would have to make assumptions about future home values that are far more pessimistic than any of the major forecasting organizations have published.

It is also possible that the anticipated duration of loans could be overstated. HECM loan duration averages fewer than seven years, with very few loans lasting far longer. Loans to younger borrowers have durations similar to loans to older borrowers, a counter-intuitive outcome. Pay-off rates for borrowers who take out loans at age 65 are the same as for borrowers who take HECMs at age 75. Sixty-five year olds tend to terminate loans when they sell and move out after less than seven years. Seventy-five year olds tend to terminate loans in less than seven years, as well, often due to a mortality event. The average duration of loans made to eighty-five year old borrowers is approximately five years.

If expected loan durations are adjusted to reflect actual experience, and future home price assumptions are conservative, but not dire, the program could, in our opinion, continue to be allowed to operate without the principal limit reductions and not require credit subsidy. In any case, that is water under the bridge now. HUD has implemented the change it felt was necessitated by OMB and its own assessment and projections. However, HUD should continue to monitor program performance and adjust the principal limits factors upward, once it regains confidence that the program is operating on a sound basis.

Testimony of Peter H. Bell, NRMLA
Before the Subcommittee on Housing & Community Opportunity
October 8, 2009

The Department appears to have taken its cue from Congressional appropriators who, in the pending FY 2010 bills, are leaning towards instructing HUD to reduce principal limit factors (PLFs), in lieu of providing credit subsidy. The principal limit factor is used to determine the percentage of value that a HECM borrower could obtain from their home.

The House bill would require HUD to do what it has already done, reduce principal limit factors by an amount that would eliminate the need for the entire credit subsidy request ($798 million). Once again, it should be noted, this comes at a high cost to some seniors. The Senate bill would provide a partial credit subsidy ($288 million) and also instruct HUD to reduce the PLFs to cover the balance, but with a smaller cut.

NRMLA fully understands and supports the need to operate the HECM program on a "negative credit subsidy" basis. We support efforts to keep the program on a self-sustaining basis. However, we also believe that there are other options for achieving this objective --changes that would have a less detrimental impact on senior homeowners.

We recently conducted an informal analysis of the loans made year-to-date by three of the most active HECM lenders. When looking at the impact of what would have happened if PLF's had been reduced to the level they were lowered to on October 1, we found that over 20% of borrowers (approximately 23,000 homeowners) would have received loan proceeds that were less than their existing indebtedness. In other words, they would be "too short to close." Because they would not receive enough money from their reverse mortgage to pay-off the existing loan on their property, they would not be eligible for the HECM, forcing them to sell and move, or possibly face foreclosure.

An alternative we recommend would be to adjust the mortgage insurance premium (MIP) to generate more income to the FHA insurance fund. The current MIP is heavily front-loaded, creating what are perceived by many to be high upfront costs for a HECM. AARP has, in fact, been historically concerned with the upfront costs to seniors utilizing the HECM program. HUD could generate the income the program needs to operate, while reducing upfront costs, by restructuring the MIP with a lower front-end amount and a higher ongoing MIP.

Right now, the HECM MIP is 2% of the value of the home at closing, plus ½% per year on the outstanding loan balance. By reducing the up-front premium to 1% or less, while raising the ongoing premium an appropriate amount, the program can be operated on an easily-adjusted self-sustaining basis, senior homeowners would not have to experience any reduction in proceeds from a HECM, and up-front costs could be lowered -- a winning combination for all.

Going forward, the management team at HUD, with the new information systems and tools available to them, should be able to monitor HECM program performance and fine-tune mortgage insurance premiums, as necessary, to maximize the benefit of the HECM program to senior homeowners – while minimizing any impact on FHA's capital reserve fund. This would be prudent management of the program and remain true to the intent of serving senior homeowners, while minimizing the need for taxpayer subsidy.

NRMLA looks forward to continuing to work with members of the Subcommittee, OMB and the Department to implement program enhancements that will keep the HECM program viable for many years to come. We appreciate the fact that key personnel at both HUD and OMB have been helpful and responsive as we have all examined various HECM-related issues.

STATEMENT OF TERESA BRYCE BEFORE THE SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPPORTUNITY OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES ON BEHALF OF THE MORTGAGE INSURANCE COMPANIES OF AMERICA
October 8, 2009

I am Teresa Bryce, president of Radian Guaranty Inc. I am here today on behalf of the Mortgage Insurance Companies of America (MICA), the trade association representing the entire private mortgage insurance industry.[1] The Subcommittee today is discussing the critical issues of the financial health of the Federal Housing Administration (FHA). Both FHA and private mortgage insurers play an important part in making homeownership affordable and possible for millions of Americans. While we cannot comment on the actuarial study since it has not been made public, we hope that by explaining the private mortgage insurance (MI) industry's regulatory structure and business model – with its rigorous reserve requirements and its natural alignment with the borrower's interests -- we can help the subcommittee determine the best way to both support and promote a vibrant and sustainable housing market.

The Role of Private Mortgage Insurance

The MI industry was founded in 1957 and since then has helped over 25 million low and moderate income people become homeowners by enabling them to buy affordable homes with small down payments. Lenders require MI on low-down payment loans because experience and research show that a borrower with less than 20% invested in a home is more likely to default on a mortgage. Today, the MI industry's capital stands behind approximately $900 billion of mortgage loans. That is approximately 9% of outstanding home mortgages held by financial institutions.

Mortgage insurers insure mortgages in all 50 states. No one market needs MI more than another because all markets have first-time home buyers struggling to achieve the dream of homeownership and enabling first-time homebuyers to purchase homes is essential to revitalizing the market. As first-time homebuyers purchase homes, existing homebuyers can trade-up to larger ones, thus ensuring a vibrant housing market.

We serve the mortgage market by providing credit enhancement – that is credit-risk mitigation – to ensure that lenders and investors such as the government sponsored enterprises (GSEs) are protected in the event of borrower default. This means that private mortgage insurers stand first in line to pay a loss if borrowers default. MI generally covers costs associated with defaulted loans (interest charges, legal fees, home maintenance and repair costs, real estate broker fees and closing costs) and any loss resulting from selling the property for less than its original sales price. In 2007 and 2008, mortgage insurers paid $15 billion in claims and continue to pay billions of dollars more in claims in 2009. Mortgage insurers are providing this protection while continuing to write new business that enables borrowers to purchase homes with small down payments and loans that are affordable for the life of the loan.

[1] The members of MICA are as follows: Genworth Mortgage Insurance Corporation; Mortgage Guaranty Insurance Corporation; PMI Mortgage Insurance Co.; Radian Guaranty Inc.; Republic Mortgage Insurance Company; and United Guaranty Corporation.

Rigorous reserve and regulatory structure - The backbone of the industry's financial strength is its state-imposed reserve, capital and regulatory requirements. It is because of this structure that mortgage insurers continue to pay their claims as they come due and write new business in these very stressful economic times. Our structure mirrors some of the key recommendations made by the heads of state at the recent G-20 summit to reform the mortgage securitization market. The key elements of the industry's regulatory structure are discussed below.

Capital at risk – While rejecting a simple risk-retention requirement because it could adversely affect credit availability, the G-20 has demanded that private capital be at risk to ensure that securitizations are based on incentives aligned with those of borrowers and investors. As noted above, mortgage insurers take the first dollar of loss if the borrower defaults, which aligns our interests with those of the borrower. Mortgage insurers' interests are also aligned with the investor who generally will take a loss if a borrower defaults. Private mortgage insurance is private sector capital at risk.

Proven ability to absorb risk (contingency reserve) – The G-20 is determined to ensure that credit default swaps (CDS) and other forms of credit enhancement have a proven ability to absorb risk. The state requirements for MI are specifically structured to address the long-term nature of the capital at risk for a mortgage insurer. They enable the mortgage insurer to withstand a sustained period of heavy defaults arising from serious regional or national economic downturns, as well as routine defaults and claims that occur throughout the normal course of business.

Mortgage insurers are required to keep three types of reserves, the most important of which is the contingency reserve. Half of each premium dollar earned goes into the contingency reserve and generally cannot be touched by the mortgage insurer for a 10-year period. It ensures that significant reserves are accumulated during good times not only to handle claims under stress, but also to avoid boom-bust cycles. Therefore, unlike other financial institutions that may pay high dividends during profitable periods, MI companies build their contingency reserves during these periods in order to have the capital ready to pay the higher claims that inevitably occur during periods of market corrections such as the one the U.S. is now experiencing.

Unlike CDS or other forms of credit enhancement, MI has already demonstrated its ability to absorb risk. The history of the MI industry proves that they have paid their claims through good and bad economic cycles. For example, in the early 1980s, the mortgage market had to cope with double-digit interest rates and inflation in a period of severe recession and, therefore, introduced many experimental adjustable-rate mortgages. As economic conditions deteriorated — particularly in energy-oriented regions of the country — defaults began to rise, resulting in numerous foreclosures. The MI industry paid more than $6 billion in claims to its policyholders during the 1980s. In the early 1990s, the MI industry paid more than $8 billion in claims, primarily in California and the Northeast. Policyholders included the GSEs, commercial banks, savings institutions, institutional mortgage investors, mortgage bankers, the Federal Deposit Insurance Corporation, and the Federal Savings and Loan Insurance Corporation.

The attached appendix is composed of three charts that provide the most recent available data. They show how the MI industry's statutory structure and resulting capital build-up allowed the industry to handle these various regional recessions described above. Mortgage insurers built capital after the oil patch recession and then were able to pay claims during the recessions in California and the Northeast. Once again the industry built capital so mortgage insurers are able to meet their claims obligations today.

Counter-cyclical capital - One reason the mortgage boom was so pronounced is that bank regulatory capital requirements permitted speculative growth and then sharply curtailed the ability of lenders to support market recovery. MI, on the other hand, is supported by a unique form of counter-cyclical capital which permits mortgage insurers – unlike every other provider of mortgage credit risk mitigation – to meet claims and handle new business even under unprecedented stress. Mortgage insurers' contingency reserves are directly comparable to the "dynamic provisioning" bank regulators now know they need. Bank regulators are only now working to construct a similar system for banks in the U.S. and around the world, with Federal Reserve Chairman Ben Bernanke highlighting this as a critical initiative.

Conservative Capital Requirements – Mortgage insurers operate within a conservative risk-to-capital ratio, with capital guidelines established by state insurance departments. MICA's member companies reported total capital of $11.98 billion against $227.7 billion of net risk-in-force as of the end of 2008, giving them a combined risk-to-capital ratio of 19 to 1. Indeed, the existing state regulatory structure has served the MI industry well during the current economic downturn.

Other regulatory features of MI - The two reserves other than the contingency reserve discussed above that mortgage insurers must maintain are case-basis loss reserves and unearned premium reserves. Case-basis loss reserves are established for estimated losses on individual policies when the insurer is notified of defaults and when foreclosures occur. Premiums received for the term of a policy are placed in unearned premium reserves and are earned over time in accordance with state regulation. As defaults have increased, the amount of capital put into these reserves has increased in order to ensure that the money is available to pay claims.

Beyond the reserves requirements, state regulators have detailed and comprehensive regulations designed to protect policyholders. State insurance regulation addresses among other issues, the licensing of companies to transact business, policy forms, claims handling, financial statements, periodic reporting, permissible investments, adherence to financial standards, and premium rates. The premium rates and policy forms are generally subject to regulation in every state and are intended to protect policyholders against the effects of excessive, inadequate or unfairly discriminatory rates and to encourage competition.

Finally, state regulations provide for a structure that allows mortgage insurers to continue to pay their claims even if they no longer write new business. One company announced last year that it would go into what is known in the industry as "run-off." That is, it collects its premiums on existing policies and pays its claims as they come due. Interestingly, a new company has announced its intention to enter the business and is raising capital and complying with the rigorous state regulations required of a new entrant.

Alignment with the borrower – Mortgage insurers and homebuyers share a common interest in the mortgage transaction because they each have the greatest risk of loss in the event of default. Upon default, the borrower will lose his or her home and the equity invested in it, and the mortgage insurer will incur a loss by paying a claim. Thus, the insurer and the borrower are both concerned that the home is affordable not only at the time of purchase, but throughout the years of homeownership. Therefore, while mortgage insurers do not interact directly with borrowers, they act as review underwriters for the credit and collateral risks related to individual loans. Mortgage insurers established independent underwriting guidelines with respect to the borrower's financial capabilities and the property value, to ensure that the borrower can afford the home.

Having its own capital at risk also means that mortgage insurers have very clear incentives to mitigate their losses if loans are in default. Mortgage insurers have a history of partnering with lenders, investors and community groups to work with borrowers in default. In today's devastating mortgage market, mortgage insurers continue to play a leadership role in working with all parties, including with the Obama Administration's HARP and HAMP programs as well as other foreclosure relief programs. In 2008 mortgage insurers were able to save almost 100,000 people from losing their homes and in the first half of this year the industry has worked to enable an additional 100,000 people to remain in their homes.

Comparison of Private MI to FHA

FHA and MI are similar in that they enable borrowers to buy homes with less than a 20% down payment by paying claims if the loan goes to foreclosure. However, there are some significant differences in the way the two models are structured. These key differences may well have come about because FHA is a government program and not a private insurance firm. However, as Congress considers ways to improve FHA's financial health it should consider attributes of the private sector that are a proven formula for success. These key differences are discussed below.

Coinsurance feature – An essential feature of private mortgage insurance is the concept of coinsurance on the part of all parties to the transaction. MI generally covers 20% to 25% of the loan amount. However, that percentage generally does not cover all of the losses that the parties to the mortgage transaction experience. FHA, on the other hand, insures 100% of the loan amount if the loan goes to foreclosure so that the loan originator lacks any meaningful risk of loss. The private MI model ensures that there is private sector capital at risk to act as a bellwether for the risk to the borrower.

Respond to market conditions – FHA has a "one size fits all" type of underwriting system which does not allow FHA to respond to the build–up or deflation of mortgage market bubbles. Mortgage insurers, on the other hand, have heavily invested in analytical and automated underwriting tools so that we can make sure the loans we insure meet our independent underwriting. Mortgage insurers are constantly monitoring the regional mortgage markets and altering their underwriting to ensure that the home is both affordable for the borrower at closing and sustainable over the life of the mortgage. If there is one thing the mortgage market has learned in recent years it is that sustainability is as important as affordability.

The members of MICA do not discuss underwriting or premium changes with each other. Therefore, I cannot speak specifically on that issue for MICA. However, I can say as president of Radian that we have adjusted our underwriting guidelines to reflect the realities of today's mortgage market. For example, as house values continue to decline around the country it only makes sense that we require that borrowers have some initial equity in their property. Therefore, in today's market we generally require a 5% down payment as we believe do most other mortgage insurers. Regarding premiums Radian's premiums are filed with and approved by state regulators to ensure that the insurer is adequately capitalized. To meet the challenges in today's market, state regulators have approved increases to Radian's premiums as they have for other mortgage insurers.

Consistent with the realities of the market place today, during the past 18 months mortgage insurers insured \$242.5 billion of mortgages which represented 9.8% of total mortgage originations during this period. However, the percentage of MI originations has declined from 14.7% in the first quarter of 2008 to 4.3% during the second quarter of 2009. This has primarily been due to the mortgage insurers changing credit guidelines and adjusting pricing to properly address the current market risks.

Appropriate Systems in Place – Over the last several years the HUD Inspector General and the General Accountability Office have enumerated various problems with FHA's automated underwriting systems and other operating systems. Because private capital is at risk, private mortgage insurers have the most current technology and can receive up-to-date information on their portfolios. This enables them to better understand trends in the market and set better criteria.

Difference in borrower profiles - The only data available to compare the typical FHA borrower to the typical borrower using MI is the Home Mortgage Disclosure Act (HMDA) data which was just made available last week for 2008. That data shows that the typical MI borrower is likely to have a slightly higher income than the typical FHA borrower because the average FHA-insured purchase loan was \$171,462 while the average privately insured purchase loan amount was \$201,539. This is also reflected in HMDA data showing that 58% of MI purchase borrowers had incomes above 100% of their metropolitan statistical area (MSA) median income whereas 45% of FHA purchase borrowers had incomes above 100% of the MSA median income.

The other characteristic that likely is different in today's market is the amount of a down payment that an FHA borrower must make as opposed to the down payment required by a mortgage insurer. FHA's minimum down payment requirement is set in law and is 3.5%. As discussed above, MICA's members make separate decisions on their down payment requirements and have the flexibility FHA does not have to make adjustments to reflect economic conditions.

Conclusion

Until the actuarial report on FHA is released, it is difficult to know exactly what changes need to be made in order to ensure that FHA continues to meet the needs of people buying homes with low down payments. The Administration has taken some good initial steps towards this goal, but it is likely more is needed. However, there is no one single change that will solve FHA's financial problems. As MICA's statement outlines, the private mortgage insurance industry, because of its stringent regulatory and reserve structure, is still paying claims and writing new business on low-down payments loans. Also, as MICA's statement discusses, many of the key factors that enable the industry to do so in this economic environment are not present in the FHA model. However, the MI industry is willing to bring its expertise to FHA and to Congress so that we can work together on a solution to ensure the existence of a robust mortgage market.

Appendix

Chart A

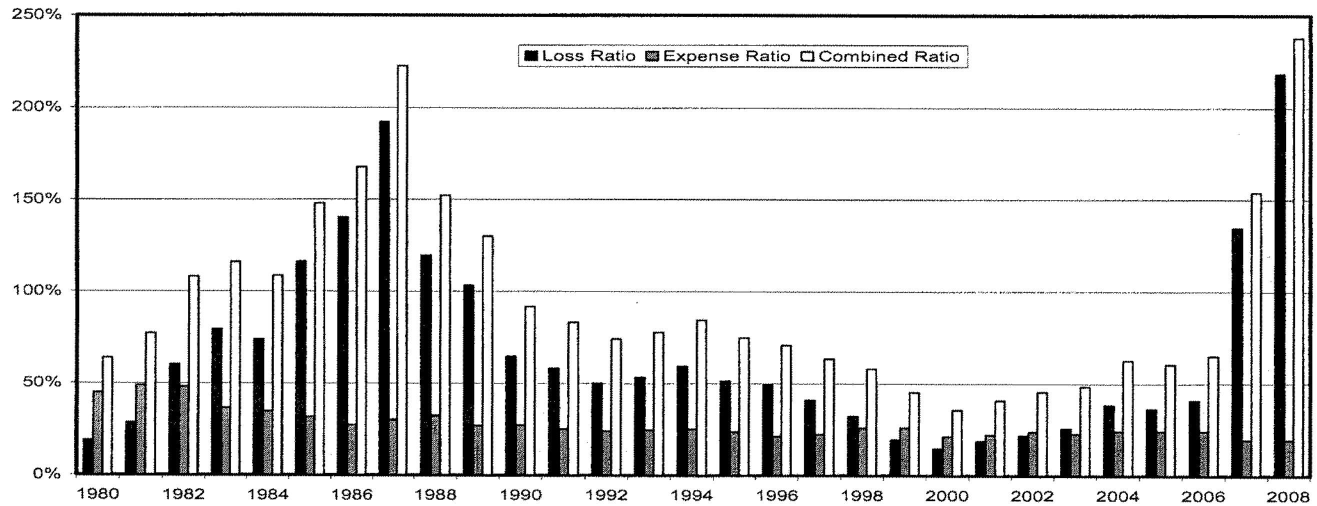

Chart A above shows the critical ratios for the MI industry from 1980 through 2008. The current stress in the housing market matches that experienced by the MI industry during the oil patch decline of the mid-1980s. However, note that the annual combined ratios exceeded 100% or more for eight straight years beginning in 1982 and the industry paid all claims and grew during that period. The reason for the continued strong claims paying ability of the MI industry is tied to its state capital and reserve requirements.

Chart B

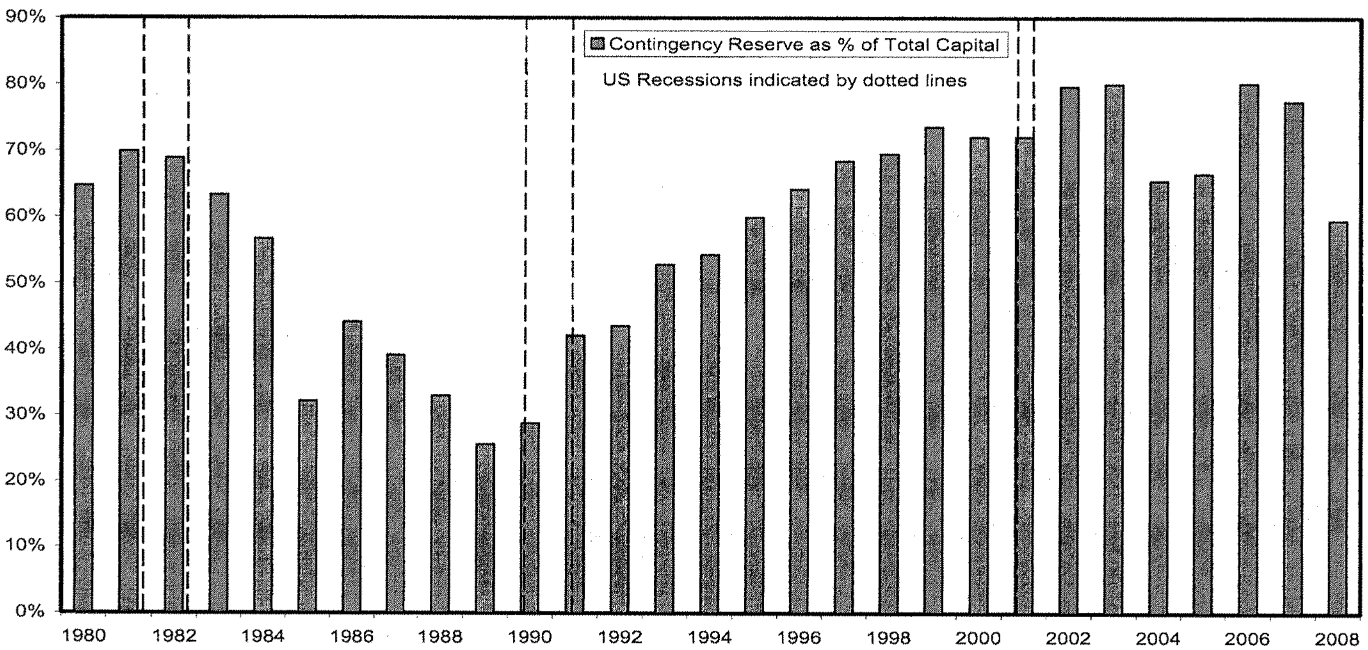

Chart B above shows how contingency reserves are built up during periods of low claims and economic prosperity to be used during periods of economic stress as we are currently experiencing.

Chart C

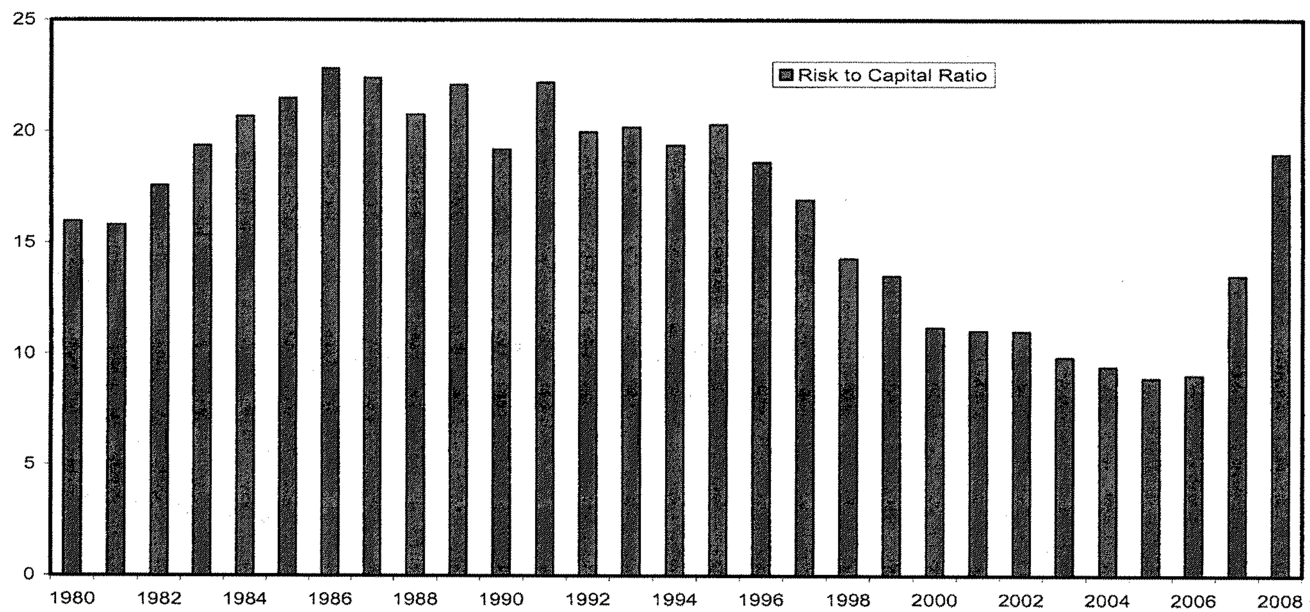

Chart C above shows the industry risk to capital ratio which now stands at 19 to 1, but still below levels seen in the mid-1990s and well below the levels reached during the mind-1980s house price declines.

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HEARING BEFORE THE

UNITED STATE HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY

ENTITLED

"THE FUTURE OF THE FEDERAL HOUSING ADMINISTRATION'S CAPITAL RESERVES: ASSUMPTIONS, PREDICTIONS AND IMPLICATIONS FOR HOMEBUYERS"

WRITTEN TESTIMONY OF

BOYD J. CAMPBELL DSC, GRI, CBR, E-PRO

ON BEHALF OF

THE NATIONAL ASSOCIATION OF REALTORS®

OCTOBER 8, 2009

Madam Chairwoman, Ranking Member Capito, and members of the Subcommittee; my name is Boyd Campbell, and I am a Managing Partner and Associate Broker for CENTURY 21 in Lanham, Maryland. I serve as a member of the Maryland Association of REALTORS® Executive Committee, and as a member of the National Association of REALTORS® GSE Presidential Advisory Board.

I am here to testify on behalf of 1.2 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the importance of FHA mortgage insurance. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential homebuyers. The Association has a long tradition of support for innovative and effective federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure federal housing programs meet their mission responsibly and efficiently.

Importance of FHA

With the collapse of the private mortgage market, the importance of the Federal Housing Administration has never been more apparent. As liquidity has dried up and underwriting standards have been squeezed tight, FHA is one of the primary sources of mortgage financing available to families today. Without FHA, families would be unable to purchase homes and communities would suffer from continued foreclosure and blight. On September 30, the Federal Reserve published its draft explanation of the 2008 Home Mortgage Disclosure Act (HMDA) data. That report shows the critical role FHA is playing in the market. According to the Federal

Reserve, by the end of 2008, nearly one half of home purchase loans and one quarter of refinancing loans were backed by either FHA or the VA. In addition, minority borrowers rely heavily on FHA. According to the Federal Reserve, "In 2008, more than 60 percent of home purchase loans and almost 40 percent of refinance loans to blacks were from either the FHA or VA. For Hispanic-white borrowers, nearly 50 percent of their 2008 home-purchase loans and 21 percent of their refinance loans were from the FHA or VA."[1]

In 1934 the Federal Housing Administration was established to provide consumers an alternative during a lending crisis similar to what we face today. At that time, short-term, interest-only and balloon loans were prevalent. FHA was an innovator with the 30-year fixed rate mortgage. Once again, FHA is now the leader in providing safe, affordable financing. The universal and consistent availability of FHA loan products is the hallmark feature of a program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity and economic downturn.

FHA Strength/Solvency

FHA has announced that their 2009 audit will demonstrate that their capital reserve fund has fallen below the Congressionally-mandated 2 percent ratio. The capital reserve ratio reflects the reserves available (after paying expected claims and expenses) as a percentage of the current portfolio, to address unexpected losses. This is not FHA's only reserve fund – FHA also has a cash reserve account separate from the capital reserve. FHA actual total reserves are higher than they have ever been – with combined assets of $30.4 billion. In fact, the audit is also expected to confirm that FHA has "positive" reserves – meaning they have adequate resources to cover all

[1] *The 2008 HMDA Data: The Mortgage Market during a Turbulent Year*, http://www.federalreserve.gov/pubs/bulletin/2009/pdf/hmda08draft.pdf

claims and expenses from their portfolio. In addition, the audit will show that if FHA makes no changes to the way they do business today, the reserves will go back above 2 percent in the next several years.

The reason the capital reserves have fallen below 2 percent actually has nothing to do with FHA's current business activities. It simply is a reflection of falling housing values in their portfolio. The economic forecaster that FHA uses to conduct their audit dramatically revised their projection of home prices from an expected increase of 2.4 percent to a loss of 10.2 percent. This significant change in assumed home price values and depreciation directly impacts the economic value of the fund. There has not been a significant increase in defaults on the part of borrowers, or underwriting problems on behalf of FHA and its lenders. Instead, the decrease in the capital reserve account is a direct effect of the state of our economy and our housing markets.

Given the devastating impact home price declines have had on banks, lenders, and even the government sponsored enterprises (GSEs) Freddie Mac and Fannie Mae, FHA has performed remarkably through this crisis. Why? FHA has never strayed from the sound underwriting and appropriate appraisals that have traditionally backed up their loans. FHA meets it mission of serving low and moderate income homebuyers, but has never resorted to abusive loans, improper or nonexistent underwriting, or other bad practices. As a participant in the home mortgage process, FHA cannot be immune to the pitfalls of the housing crisis. But solid policies and practices have protected it from the biggest failures.

Today, FHA borrowers have never been stronger. The Federal Reserve report shows that FHA is not the new subprime lender - its FICO scores have increased, and its LTVs decreased. The average credit score for FHA's current customer has grown to 693, and only 7.5 percent of their purchase borrowers this year had FICO scores below 620. Borrowers have more equity, as the percentage of FHA's Loan-to-Value (LTV) ratios above 95% fell from 72 percent in 2007 to 62 percent in 2008. FHA's cash reserves are strong, and sufficient to pay claims. We believe FHA is taking the necessary steps to assure it remains a critical source of mortgage insurance for America's homebuyers at all times – good and bad.

FHA's New and Proposed Changes

While FHA is not required to do anything when the reserves fall below 2 percent FHA is appropriately taking some steps to improve their position. First, they are hiring a Chief Risk Officer to oversee FHA's efforts to mitigate risk. We applaud the leadership of FHA Commissioner Dave Stevens for making this decision so quickly after taking office. A Chief Risk Officer will have the primary responsibility for overseeing risk management across all FHA programs. We believe FHA has taken strong measures to mitigate risk, but assigning one senior staff member with the responsibility for coordinating FHA's risk management activities makes good sense.

FHA has also announced that it will modify its procedures for streamlined refinancing. For those borrowers who apply for a simple refinance loan, with no cash out, FHA will now require a short seasoning period for the original loan (6 payments), the lender to demonstrate a net benefit to the consumer, and the borrower to exhibit an acceptable payment history. We do not think any of these changes are onerous for consumers, and strongly admire FHA for including the "net benefit" requirement to assure consumers aren't bearing the costs of refinancing, without receiving any benefit. In addition, lenders must verify that the borrower is employed and has income at the time of the refinance. While we understand the logic of this requirement, we question what will occur in the case where a borrower has lost employment, is still making their mortgage payments, and the refinance would make it easier for them to make those payments (net tangible benefit). Would those borrowers – whose risk is already borne by FHA – be ineligible for a refinance? Where the borrower will take cash out of the transaction, we support FHA's changes to require additional underwriting and property appraisals.

FHA has also released mortgagee letters on appraiser independence, effective January 1, 2010. We support FHA's language related to geographic competence, especially as it relates to the use of Appraisal Management Companies (AMCs). FHA does not require lenders to utilize AMCs, and reinforces the importance of geographic competence. Consumers and REALTORS® have encountered significant problems with appraisals when the appraiser is not familiar with the community in which the home is located. FHA's mortgagee letter states that lenders and appraisers are both responsible for the quality and accuracy of the appraisal. FHA states that the lender is responsible for determining whether an appraiser's qualifications are sufficient prior to assigning an appraisal. Appraisers are reminded that USPAP applies to all appraisals performed for properties that are security for FHA. In addition, FHA's letter states that if the lender orders an appraisal through an AMC or another third party organization the lender must ensure that specific guidelines are followed to ensure the FHA appraiser is compensated appropriately and that the fee charged to the consumer for the appraisal report is consistent with the market rate for appraisals.

The letter also provides guidance on the subject of appraisal portability. NAR believes it is important for borrowers to have complete flexibility in choosing a lender, and should not be hampered by having to repeat an appraisal simply because they switched lenders. NAR feels strongly that consumers should not be required to pay excessive fees for appraisals, nor be subject to appraisals conducted by appraisers who are not familiar with their market. Mortgage brokers and lenders underwriting staff will be prohibited from ordering the appraisal. This will create a firewall between lending staff and the appraiser and enhance the independence of the appraisal process. To further support the independence of appraisers and to ensure uniformity in the real estate industry we have called on FHA to work with the GSEs to established a combined frequently asked questions (FAQ) document that will be codified in existing appraisal policies. In a recent meeting, FHA Commissioner David H. Stevens has asked his staff to begin discussions with the GSEs to further explore this recommendation. We support these changes by FHA.

FHA will also begin rulemaking dealing with mortgage lenders and brokers. They will propose to increase the net-worth requirements for mortgagees to $1 million (from $250,000) and will place liability for mortgage brokers' actions on the lender. NAR does not have data or policy on these specific lender issues. However, such actions would put FHA in-line with industry standards, and do not appear to be particularly onerous for lenders. Assuming FHA has data to show that these changes are needed to help retain the safety and soundness of the FHA fund, we would support these proposals.

NAR Additional Recommendations for FHA

NAR does support some additional changes for FHA to ensure its continued strength and availability to homeowners.

Technology and Staffing

NAR strongly supports increased funding for FHA to upgrade their technology. FHA operates with technology that is an average of 18 years old. Quickly upgrading the dozens of incompatible systems, such as the 30 year old COBOL system, to web based customer centric applications is necessary for the agency's continued existence and future success. Legislation has recently passed the House, H.R. 3146, the "21st Century FHA Housing Act of 2009," which would provide this authorization. This bill, introduced by Representatives Adler (D-NJ) and Lee (R-NY), will provide a number of reforms to modernize FHA. We also understand funding has been included in the Appropriations bill for HUD, and we urge that funding to be included in the final version of the FY2010 Appropriation for HUD.

We also believe HUD should have the ability to hire the professional staff they need to run what is now such a large and critical component of our housing finance system. H.R. 3146 provides HUD flexibility to hire appropriate staff using the compensation guidelines of similar agencies, such as the Federal Housing Finance Agency or the Federal Deposit Insurance Corporation. The legislation would also permit the hiring of expert consultants to work on specific program areas within FHA's operations. We think these changes are necessary to ensure the FHA is able to work efficiently and effectively with qualified, experienced staff.

Condominium Rules

NAR has also been working closely with FHA on their new condominium approval process. As originally published in Mortgagee Letter 2009-19, we have concerns that some components of the new policy may lengthen the real estate crisis, just as some markets are seeing positive growth. We applaud the Department for delaying implementation of this letter, and believe they are making some changes to their policies.

NAR recommends elimination of the owner-occupancy requirement for FHA condo mortgages. The GSEs do not have an occupancy ratio for condominium projects if the borrower is going to occupy the unit, which of course would be the case for all FHA borrowers. Eliminating this requirement will allow more buyers to purchase condominiums (which are often more affordable), raise occupancy levels, and will stabilize these developments and the community. If FHA retains the occupancy ratio, NAR recommends amending the rules so that all bank-owned REOs are not counted for the purposes of the occupancy ratio. Again, this will align FHA with the industry practices in this area.

Condominiums are often the only affordable option for first time home buyers or borrowers with good credit, but small downpayments. NAR recommends amending the FHA concentration requirement. Currently, no more than 30 percent of the total units in a project may have an FHA mortgage. Increasing this limit, or temporarily suspending it, will result in a greater owner-occupied ratio in the project because more borrowers will be able to use FHA to purchase.

Many condominiums remain largely vacant because of our real estate crisis. But FHA requires that at least 50 percent of the units be sold prior to FHA's endorsement on a unit. This eliminates condominiums as an option for many FHA borrowers. Reducing or eliminating this requirement grants greater choice for the borrower but also helps reduce the number of vacant units on the market.

NAR urges FHA to clarify the condominium reserve study requirements. Currently the reserve study requirement can be financially costly for small condominium associations and can cause delays in completing sales. We urge FHA to clearly state what has to be included in the study and who should conduct and bear the costs of the study.

Lastly, NAR recommends FHA reconsider the elimination of the Spot Loan Approval Process. Spot loans can be critical for borrowers who wish to use FHA to purchase a condominium in a project that is not FHA approved. Elimination of the Spot Loan Approval Process effectively reduces consumer choice in condominiums as there will likely be many projects not approved by FHA but a logical choice for potential homeowners.

Mortgage Loan Limits

We also strongly support making permanent the FHA mortgage loan limits that are currently in effect. FHA has played a critical role in providing mortgage liquidity as private financing has dried up. The current loan limits are set to expire in just a few months, on December 31, 2009. Last year, when the limits temporarily expired, many communities saw dramatic declines in mortgage liquidity. More than 612 counties in 40 states and the District of Columbia saw their limits fall. The average decline in the loan limits was more than $51,000.

In today's real estate market, lowering the loan limits further restricts liquidity and makes mortgages more expensive for households nationwide. FHA and GSE mortgages together continue to constitute the vast majority of home financing availability today, which makes it particularly critical to extend the current limits. Without the additional liquidity created by maintaining these loan limits at current levels, families will have to pay more to purchase homes, face the possibility that they will not be able to obtain financing at any price or find it more difficult or impossible to refinance problematic loans into safer, more affordable mortgages.

We strongly support the legislation introduced by Committee members Brad Sherman (D-CA) and Gary Miller (R-CA), H.R. 2483, the "Increasing Homeownership Opportunities Act" to make the current loan limits permanent. We urge the Subcommittee quickly consider this important legislation to ensure that liquidity in this tenuous market is not put at risk.

Other Needs for a Housing Recovery

NAR would also like to take this opportunity to suggest some other necessary changes that Congress can implement to aid in our housing recovery. Most economists agree that our housing markets are slowly coming back. Some areas are starting to see price stability and even revival. But a number of federal actions have lead to this and need to be continued and additional steps needs to be taken to get our country back on its feet.

Extend the 1st Time Homebuyer Tax Credit

The $8000 first-time homebuyer tax credit expires as of December 1, 2009. But the usefulness of the credit diminishes daily if the credit is not extended well before that date. A homebuyer is eligible for the tax credit only if the home is "purchased" before December 1, 2009. That means that buyers have to find a house, complete a contract, satisfy any contingencies, secure financing and go to closing by November 30. Accomplishing those tasks by November 30 will become more difficult with every passing day. In today's market, it generally takes between 45 and 60 days to go from contract to closing. Without Congressional action now, the market may freeze again – possibly as soon as this month. NAR's research suggests that as many as 350,000 sales this year can be directly attributed to the availability of the credit. The tax credit stimulated market activity. The volume of housing sales has improved steadily every month since the credit was enacted. The credit pulled people from the sidelines and created some momentum that had been absent.

The housing market remains fragile. The market has improved and prices have stabilized in many areas, but the market has not fully corrected. Retaining the tax credit sustains that recovery. Inventory may remain unusually high. The waves of foreclosures attributable to subprime and other improper lending practices are working themselves through the system. Presently, high unemployment rates pose a threat to homeowners and could set another round of foreclosures in motion. If foreclosure rates were to spike again, inventories could become bloated again. Incentives are still needed to keep the market moving.

Home sales continue to stimulate economic activity. The economy will never fully recover until housing markets fully recover. Thus, the stimulus the credit provides is still needed. NAR estimates that every sale generates approximately $60,000 of additional economic activity. And expanding the credit beyond first-time homebuyers would give the economy a much needed kick. We continue to need the homebuyer credit. Congress must act <u>now</u> to be sure that the credit is available through 2010.

<u>Uniform Short Sales Policies</u>

Due to the recent economic crisis, including rising unemployment, and drops in home prices in communities across the nation, the number of short sales is increasing. Since a short sale generally costs the lender less than a foreclosure, it can be a viable way for a lender to minimize its losses. A short sale can also be the best option for homeowners who are "upside down" on mortgages because a short sale may not hurt their credit history as much as a foreclosure. As a result, homeowners may qualify for another mortgage sooner once they get back on their feet financially.

However, too often, a short sale is a story of delay, unrealistic expectations of the value of the home, lost documents, full voicemail boxes, and insufficient or untrained staff. NAR has been working with lenders and servicers to try and ease the closing of short sales. As you know, the vast majority of short sales never close – even after the offer has been accepted. On May 14, 2009, the Administration announced incentives and uniform procedures for short sales under a new Foreclosure Alternative Program. These guidelines and forms are in the process of being completed, and are expected to be released later this month. NAR was extremely pleased that the Administration heard the concerns of our members that short sales reform is crucial to helping families, who are unable to keep their homes, nevertheless avoid foreclosure.

The new program offers the hope of uniformity, transparency, and speed. But those goals will only be achieved if a large majority of servicers agree to participate and if they apply it uniformly to all eligible families. Completed short sales are not only good for the seller and the buyer, but saves the lender tens of thousands of dollars and benefits the community by keeping the home occupied and maintained. REALTORS® anxiously await implementation of the program and continue to report, every day, problems getting short sales to closing resulting in unnecessary foreclosures.

Conclusion

The National Association of REALTORS® believes in the importance of FHA and thinks it has shown tremendous leadership and strength during the current crisis. FHA remains fiscally safe and sound. Due to solid underwriting requirements and responsible lending practices, FHA has avoided the brunt of defaults and foreclosures facing the rest of the real estate finance industry. We applaud FHA for continuing to serve the needs of hardworking American families who wish to purchase a home.

We believe Congress and the Administration are taking the right steps to facilitate the economic recovery. We urge them not to stop now. Additional resources are needed to ensure the housing markets and our national economy continues to improve. We thank you for this opportunity to testify, and stand ready to work with you to accomplish our recommended proposals.

National Association of Mortgage Brokers

Prepared Testimony

of

John Councilman, CMC, CRMS
FHA Committee Chairman

National Association of Mortgage Brokers

on

"The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers"

Before the

Committee on Financial Services,
Subcommittee on Housing & Community Opportunity

United States House of Representatives

October 8, 2009

Good afternoon Chairwoman Waters, Ranking Member Capito, and members of the Committee. I am John Councilman, chairman of the Federal Housing Administration ("FHA") Committee of the National Association of Mortgage Brokers ("NAMB"). I am a Certified Mortgage Consultant ("CMC") and Certified Residential Mortgage Specialist ("CRMS"), with over 26 years of experience as a mortgage professional in the state of Maryland. Thank you for inviting me to testify today on "The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers."

I. Introduction

NAMB is the only national trade association representing the mortgage broker industry. NAMB advocates on behalf of more than 70,000 mortgage professionals nationwide. NAMB also represents the interests of homebuyers, and advocates for public policies that serve mortgage consumers by promoting competition, facilitating homeownership and ensuring quality service.

NAMB is committed to enhancing consumer protection and promoting the highest degree of professionalism and ethical standards for its members. NAMB requires its members to adhere to a professional code of ethics and best lending practices that fosters integrity, professionalism and confidentiality when working with consumers. NAMB provides its members with access to professional education opportunities and offers rigorous certification programs, including the CMC and CRMS, to recognize members with the highest levels of professional knowledge and education. NAMB also serves the public directly by sponsoring consumer education programs for current and aspiring homebuyers seeking mortgage loans.

NAMB members are typically small business owners, employing between three and fifty employees. They serve both urban and rural communities of every size, and operate in all 50 states and the District of Columbia. NAMB members work with consumers as they make their way through the complex mortgage origination process, and add value to that process for both consumers and lenders by serving many areas that are typically underserved by banks and other financial institutions. Because many NAMB members establish and operate their businesses exclusively within the communities they serve, these individuals also add value to the origination process by providing goods, facilities, and services with quantifiable value, including a loyal customer base and goodwill.

NAMB members, together with the rest of the mortgage broker industry, bring greater competition to the market for origination services and typically provide consumers with a local alternative to using a large national bank or lender.

II. The Role of Mortgage Brokers

A mortgage broker is a real estate financing professional or entity that works with borrowers and lenders, while representing neither, to obtain a mortgage loan. A mortgage broker's value lays in the broker's ability to provide goods, services, and facilities with quantifiable value, including a customer base and goodwill.

Because a mortgage broker works with consumers throughout the entire mortgage origination process, a broker's role may include: taking an application; performing a financial and credit evaluation; producing documents; working with Realtors; ordering title searches, appraisals, and pay-off letters; assisting in remedying faulty credit reports or title problems; and facilitating loan closings. The assistance a mortgage broker provides often varies widely, depending on the nature of the transaction, the requirements of the customer, lender, or loan purchaser, and other factors.

A mortgage broker may have a working relationship with one or more banks or other lenders and may provide the consumer with access to a wide range of options for financing a home. This allows mortgage brokers to provide consumers a highly efficient and cost-effective means of obtaining a mortgage that satisfies the consumer's financial goals and circumstances.

Mortgage brokers also facilitate competition in the marketplace and help drive down origination costs for borrowers. A 2005 independent study conducted by economists at three major universities concluded that "broker-originated mortgages are less costly to the borrower than lender-originated mortgages after holding other loan terms and borrower characteristics constant."[1] Similarly, a study by Richard Todd of the Federal Reserve Bank of Minneapolis and Professor Morris Kleiner of the University of Minnesota

[1] Amany El Anshasy (George Washington University), Gregory Ellihausen (Georgetown University) & Yoshiaki Shimazaki (Oklahoma State University), *The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders*, July 2005 ("Mortgage Pricing Study"), at 12.

found that "[b]rokers have helped to shorten the loan process and made it cheaper."[2] This study also showed when certain state regulatory burdens were imposed on brokers, impeding brokers' entry into mortgage markets, the number of brokers declined, and those states experienced "higher foreclosure rates, and a greater percentage of high-interest-rate mortgages."[3]

III. Mortgage Broker Participation in FHA

Before we discuss the process by which mortgage brokers may become approved by FHA, it is important to identify the specific role a mortgage broker plays in originating an FHA loan.

A mortgage broker is responsible for taking a consumer's loan application, obtaining merged credit reports and importing loan application data to the FHA system. The mortgage broker then enters his or her FHA correspondent ID and the sponsoring wholesaler FHA lender ID. The next step involves sending the borrower's information through Freddie Mac's Loan Prospector or Fannie Mae's Desktop Underwriter system, both of which are programmed with FHA Total Scorecard underwriting parameters. At this point, the mortgage broker receives a full "FHA Total Scorecard Feedback Certificate." Next, the mortgage broker processes the information he or she has collected from the borrower and sends the full file to the sponsoring FHA lender. Finally, the sponsoring lender reviews the "FHA Total Scorecard Feedback Certificate," underwrites the loan per FHA requirements, and makes the final lending decision.

In a FHA mortgage transaction, both the lender and the mortgage broker must be approved by FHA. FHA approves mortgage originators based on the function(s) they will perform during a transaction, as well as by the type of entity or organization they are.

There are four basic types of FHA-approved originators. They are "supervised mortgagees," who are members of the Federal Reserve and whose accounts are insured by either the Federal Deposit Insurance Corporation (FDIC), or the National Credit Union Administration (NCUA); "non-supervised mortgagees" (*i.e.*, mortgage lenders), who are not depository institutions; and "supervised and non-supervised loan correspondents." Non-supervised loan correspondents are typically mortgage brokers, having as their principal activity the origination of FHA-insured mortgages for sale or transfer to one or more sponsoring lenders who are responsible for underwriting the mortgages.

All loan correspondents must be sponsored by a fully approved supervised or non-supervised direct endorsement ("DE") lender, who agrees to underwrite and fund the loan originated by the FHA correspondent. The loan correspondent retains the option to either close the loan in its own name or in the name of the sponsoring DE lender. Traditionally, mortgage brokers will close the loan in the name of their underwriting sponsor. Loan correspondents never underwrite any FHA loans.

Most NAMB members participating in the FHA program are non-supervised loan correspondents. As loan correspondents, these originators are required to have at least one sponsoring DE lender who is a FHA-approved mortgagee. That sponsor must agree to underwrite and fund the loans originated by the correspondent that satisfy the requirements of FHA and the sponsor's lending criteria. Both the loan correspondent and the sponsoring DE lender are responsible for adhering to all FHA regulations and guidelines.

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[2] Morris Kleiner & Richard Todd, *Mortgage Broker Regulations that Matter: Analyzing Earnings, Employment, and Outcomes for Consumers*, National Bureau of Economic Research Working Paper 13684 (December 2007) ("Broker Regulations Analysis") at 7.

[3] Broker Regulations Analysis at 1.

The process through which a mortgage broker becomes a FHA-approved loan correspondent takes considerable effort. There are currently many structural requirements, investigations, net worth requirements, audited financial statements, staffing requirements and additional information required for approval. Additionally, these requirements are continuing in nature and must be recertified to FHA each year.[4]

Every FHA-approved mortgagee and loan correspondent is required to renew its approval status annually. HUD then reviews statistics and other information regarding each approved mortgagee and loan correspondent to determine if continued approval is appropriate. All mortgagees are required to submit an annual verification report, and most pay an annual renewal fee. Non-supervised mortgagees and non-supervised loan correspondents are also required to submit audited financial statements and supplementary reports each year.

IV. Preventing Fraud in the Mortgage Industry

NAMB was the first, and for many years the only industry representative in Washington, D.C. calling for heightened professional standards for all mortgage originators. Since 2002, NAMB consistently advocated for a licensing and registration regime for all mortgage originators, which would include criminal background investigations, proficiency testing, and continuing education.

NAMB's vision was realized when the S.A.F.E Mortgage Licensing Act ("SAFE Act") was signed into law in July 2008 as part of the Housing and Economic Recovery Act. The SAFE Act established a nationwide licensing and registration system for mortgage originators. Under the system, all mortgage originators, regardless of whether they are state or federally-regulated, are required to submit fingerprints to the FBI, and any other governmental agency or entity authorized to receive such information for a state and national criminal background check, and must obtain a unique identifier through the Nationwide Mortgage Licensing System and Registry administered by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators ("CSBS/AARMR"). Additionally, all state-licensed loan originators are required to meet minimum education and testing standards.

The SAFE Act represents a critical step toward achieving the higher level of uniformity and professionalism in the mortgage lending industry that NAMB has advocated for so many years. Mandating education and testing for every mortgage originator helps ensure that consumers will receive accurate and consistent product information, which will allow them to make an informed decision about different loan financing options available in the market. Additionally, mandatory continuing education and professional ethics training helps ensure that mortgage originators remain knowledgeable and competent to address consumer concerns. Finally, state and federal criminal background checks are the most effective means of preventing unqualified individuals from entering, remaining, or moving within the mortgage industry.

In addition to the tremendous effort expended in support of implementing a nationwide licensing and registration system for mortgage originators, NAMB has diligently monitored trends in the mortgage origination industry that might pose a threat to consumers, to FHA, or to the industry in general. One such threat that NAMB has been able to identify and encourage FHA to explore further involves "non-approved counselors." These counselors are essentially individuals who have found a way to operate outside of the standards set forth by FHA. Non-approved counselors originate FHA loans and receive a fee for providing this service to consumers. However, these counselors are not required to adhere to any of the FHA origination requirements and are not employees of or affiliated with any approved mortgagee, effectively circumventing the approval process that exists today. Such counselors are not required to be

[4] Appendix A: John Councilman, *What it Takes to be FHA Approved*, Mortgage Press (November 2008).

licensed, as they are only being paid for "counseling services" and cannot take a loan application, verify data or give disclosures; yet they often collect one to two percent of the loan's value, which often amounts to thousands of dollars. Additionally, the fees charged by these counselors are not typically paid by the FHA-approved mortgagee, but rather by the consumer from his or her own available funds. This loophole, which essentially allows unlicensed individuals with no credentials or checks to advertise that they can provide FHA loans, was identified by NAMB and brought to the immediate attention of the U.S. Department of Housing and Urban Development ("HUD").

Finally, NAMB has adopted and continually works to strengthen a professional Code of Ethics and Best Lending Practices that all NAMB members are required to adhere to. NAMB also provides its members with state-approved education courses covering critical topics such as ethics and professionalism, as well as specialized topics including participation in FHA and other loan programs. Finally, NAMB offers professional certification opportunities for its members that require candidates to educate themselves beyond most state licensing requirements and meet rigorous testing requirements that carry a high rate of failure.

V. FHA is Not the New Subprime

With the collapse of the subprime market, many are concerned that the problems leading to that collapse will begin to creep into the FHA market and expose the FHA insurance fund to greater risk. However, NAMB strongly believes that the FHA rules and policies currently in place, together with the larger reforms across the entire mortgage industry, will be sufficient to prevent this from happening.

First, and most importantly, the SAFE Act has significantly increased professional standards and accountability for all mortgage originators. Today, as opposed to during the peak of the subprime lending boom, it is extremely difficult for bad actors to enter, remain, or move within the mortgage industry to prey on consumers. Additionally, FHA imposes its own requirements for mortgagees and loan correspondents, which further vets the individuals and entities that may be approved to participate in the program.

Finally, much like originators, borrowers using FHA must adhere to higher standards than the ones which existed in the subprime market. Some of these higher standards include income verification, mandatory downpayment requirements and strict loan-to-value ratios. Additionally, FHA does not permit many of the loan product features, such as prepayment penalties, huge payment spikes and negative amortization, which exposed borrowers and lenders to greater risk and were prevalent in so many loans made in the subprime market. FHA also requires borrowers to occupy the home they are purchasing as their primary residence, which was never a requirement in the subprime market.

There has almost certainly been some migration of mortgage originators from the subprime market over to FHA, since a significant majority of the mortgage industry was involved in some way with subprime lending. However, with the safeguards that are now in place at FHA and throughout the mortgage industry, this migration should not be viewed as a threat to the FHA program, but rather as a tremendous opportunity for growth. Now, perhaps more than ever, highly qualified and well-established mortgage originators are again looking to FHA as a means of offering an affordable loan product to their customers. This renewed interest in the FHA program, coupled with heightened standards for every mortgage originator who wishes to remain in the industry, should position FHA to recapture much of the market share that was lost to the subprime market over the past decade.

VI. FHA Policy Changes being Pursued by Mortgagee Letter, Effective January 1st

FHA Commissioner David Stevens has proposed a number of sweeping policy changes to the FHA loan program. These new policies proposed by Commissioner Stevens will have a profound effect on the FHA program and will greatly impact mortgage brokers.

NAMB applauds Commissioner Stevens for his work in putting these new policies into place, and we are largely supportive of his efforts to improve the FHA loan program. However, NAMB does believe there are areas in the new system that will need to be addressed, and those areas must be worked out to ensure that the system continues to run efficiently and effectively into the future.

1. Appraiser Independence

FHA is proposing new guidelines on ordering appraisals for FHA insured mortgages that it believes will enhance appraiser independence and geographic competence. The new guidelines prohibit mortgage brokers and commission-based lender loan officers from ordering appraisals, much like the Home Valuation Code of Conduct ("HVCC"), which was implemented by Fannie Mae and Freddie Mac (together, "the GSEs") in May 2009. FHA believes its existing policies regarding appraiser independence are consistent with the HVCC, and FHA says it will adopt language from the HVCC to ensure full alignment of FHA and GSE standards.

The HVCC is a highly controversial shift in appraisal policy that is the result of a joint agreement reached between the GSEs, the Federal Housing Finance Agency ("FHFA"), and New York Attorney General, Andrew Cuomo. The HVCC purports to enhance the independence and accuracy of the appraisal process. However, what the HVCC truly accomplishes is an increase in consumer costs, a decline in appraisal quality, the extension of closing deadlines, and the virtual extinction of independent appraisers.

Although FHA has varied the provisions of the HVCC slightly in Mortgagee Letter 2009-28, these variations are unlikely to allow FHA to escape any of the serious issues currently facing consumers and originators in the conventional mortgage market as a result of the HVCC.

NAMB believes it is important to strengthen the integrity and independence of the home appraisal process, as appraiser independence is essential to protecting consumers and the FHA insurance fund from fraud and unnecessary risk. However, NAMB does not believe the HVCC, or the new FHA appraisal guidelines, will effectively achieve these goals.

The impetus behind these new appraisal policies – the HVCC and the new FHA guidelines – is the perception that appraisers were being pressured or improperly influenced by mortgage originators. However, the HVCC is failing to provide any greater protection for appraisers. Appraisers are still subjected to significant pressure and undue influence, but instead of coming from mortgage originators it is now coming from the Appraisal Management Companies ("AMCs") that were granted a virtual monopoly over the appraisal process by the HVCC.

In fact, a growing number of appraisers are reporting that the pressure and attempts to improperly influence their professional judgment is far worse under the AMC dominated regime prescribed by the HVCC than it ever was when appraisers were permitted to work directly with originators. Specifically, appraisers are reporting that AMCs are requiring them to prepare appraisals in violation of the Uniform Standards of Professional Appraisal Practice ("USPAP") and generally accepted appraisal guidelines.

Today, unlike when an appraiser had multiple mortgage broker and/or loan officer clients, the HVCC has restricted their work to be on behalf of only one or possibly two AMCs. Under this construct, if an appraiser fails to comply with any AMC "request," they will no longer receive appraisal assignments from possibly their only client. With many knowledgeable and skilled appraisers unwilling to work under such conditions and consequently leaving the profession, the appraisers that remain willing to work for the AMCs are generally far less qualified and experienced. This has resulted in a rapid decline in appraisal quality since the implementation of the HVCC, which directly contradicts the widely purported view of HVCC proponents that turning over virtually exclusive authority for appraisal ordering to third-party AMCs would produce more accurate appraisals.

Although it can be fairly said that conducting appraisals is both a science and an art form, there is evidence showing that multiple appraisals ordered on the same property under the HVCC can vary by more than 20%. While it is unrealistic to expect multiple appraisals to come in with values that fall within a tight tolerance window, the extremely large variances we are seeing on multiple appraisals under the HVCC are cause for great concern.

Moreover, with the virtual elimination of all competition in the market for home appraisals, AMCs have reduced appraisers' fees by as much as 50%, while at the same time increasing consumer costs for appraisals by more than 50%. HUD believes it has solved this problem by making the AMCs pay rates that are "customary and reasonable" for the area where a property is located. However, with AMCs dominating the market and most AMCs underpaying appraisers for their work, it will likely prove to be extremely difficult to establish what "customary and reasonable" really means.

NAMB strongly opposes FHA's decision to follow in the footsteps of the HVCC, given its glaring weaknesses and failures in the short time since it has taken effect. Moreover, NAMB believes FHA already has a more effective mechanism in place for assuring appraiser independence, as every FHA appraisal is reviewed by the sponsoring DE lender's underwriter prior to loan approval. This system of checks has served FHA well for years and we believe would continue to do so in the absence of the proposed new appraisal guidelines. Finally, NAMB believes that adequate additional safeguards were put in place by the amendments to Regulation Z of the Truth-in-Lending Act, which took effect October 1, 2009.[5]

Prior to HUD's announcement of these proposed new appraisal guidelines, FHA was the only remaining segment of the market where independent appraisers could receive a fair wage and operate without unreasonable pressure, scrutiny or restraints. NAMB strongly encourages HUD to consider withdrawing Mortgagee Letter 2009-28 and engage representatives from both the mortgage and appraisal industries in meaningful discussions of alternative approaches prior to implementing the proposed guidelines or any other significant changes to the appraisal ordering process for FHA.

2. *Appraisal Portability*

Mortgagee Letter 2009-29 specifically addresses the issue of appraisal portability, which is another tremendous problem created by the HVCC. FHA proposes new guidelines that would allow a second appraisal to be ordered under a limited set of circumstances when a borrower switches from one lender to another and restates the requirement that the first lender must transfer the appraisal to the second lender at the request of the borrower. These new guidelines are designed to prevent delays in closing that often occur when a loan is transferred from one lender to another.

NAMB strongly supports FHA's effort to increase appraisal portability. However, we are concerned that this new FHA policy, as written, will fail to achieve its intended goal. As long as mortgage brokers are prohibited from ordering appraisals for their customers, they cannot be identified as the "client," and the appraisal will not truly be portable.

[5] Truth in Lending, 73 Fed. Reg. 44522 (July 30, 2008) (to be codified at 12 C.F.R. 226.36(b)).

Appraisals are addressed to the "client" who orders the appraisal. USPAP prohibits the "readdressing" of appraisals. When mortgage brokers order an appraisal, the broker is the "client" and that appraisal may be freely transferred to any FHA approved sponsoring lender with whom the broker maintains a relationship. However, if lenders are required to order the appraisal and are identified as the "client," not even HUD's mandate that an appraisal must be transferred from one lender to another upon a borrower's request will permit readdressing the appraisal to the second lender. Moreover, even if a transfer of the appraisal was lawful, the time that would almost certainly be lost in that process would prove to be severely damaging to the borrower.

3. Modified Procedures for Streamlined Refinance Transactions

FHA proposes modifying certain procedures for streamline refinance transactions to: establish new requirements for seasoning, payment history, income verification, and demonstration of net tangible benefit to the borrower; provide for collection of credit score information when available; and cap the maximum loan-to-value ratio at 125%. An appraisal would be required in all cases where a borrower wants to add closing costs to the transaction. These revisions will bring documentation standards for streamline refinance transactions in line with other FHA loan origination guidelines, ensure a borrower's capacity to repay the new mortgage, and prohibit the dangerous practice of loan churning, where borrowers raise cash through successive cash-out refinancings that put them further in debt.

NAMB is concerned that many borrowers will not be able to refinance to a lower rate, which could possibly increase the default rate rather than provide an equity cushion had the borrower not refinanced.

VII. FHA Policy Changes being Pursued by Rulemaking

1. Modified Mortgagee Approval and Participation in FHA Loan Origination

Lenders seeking approval to originate, underwrite or service an FHA loan would be required meet the eligibility criteria for a supervised or non-supervised mortgagee. Approved mortgagees would be required to assume liability for all the loans they originate and/or underwrite. Loan correspondents would be eliminated, but third-party originators would continue to be permitted to originate FHA insured loans through their relationships with approved mortgagees. Third-party originators would no longer receive independent FHA approval or maintain any status with FHA.

These proposed policy changes would require FHA approved mortgagees to assume responsibility and liability for every FHA insured loan underwritten and closed by the mortgagee. HUD believes these changes align FHA with the GSEs and could potentially increase the number of third-party originators who are eligible to originate FHA insured loans. HUD also believes these changes will provide for more effective oversight of third-party originators through the supervision of FHA approved mortgagees.

NAMB has long advocated for changes to the FHA approval process that would help a greater number of third-party originators become eligible to originate FHA loans. Therefore NAMB is very supportive of Commissioner Stevens' efforts to increase opportunities for third-party originators to participate in the FHA program. NAMB also shares Commissioner Stevens' belief that maintaining annual audit and net worth requirements for third-party originators does not protect HUD as well as other available methods of supervision.

Nevertheless, NAMB is concerned that the total elimination of loan correspondents from the FHA program may fail to adequately represent the widely varied participants in today's mortgage market and will almost certainly not serve the best interests of consumers.

It is a common misperception that the term loan correspondent is synonymous with mortgage broker. In reality, FHA loan correspondents take various forms, including small banks that lack the staff to perform all FHA functions, independent mortgage bankers who do not desire to service FHA loans and mortgage brokers who possess the requisite expertise but need a funding partner. This is why NAMB believes it is important for these entities that occupy the space in between FHA approved mortgagees and true third-party originators to have an opportunity to receive independent FHA approval, maintain some status with HUD and the FHA, and retain access to the FHA system.

If qualified loan correspondents are not properly accounted for under a new system for determining participation in the FHA program, borrowers choosing to work with these entities will be forced to apply blindly for FHA loans because their chosen originator will not have the necessary access to Total Scorecard or the FHA Connection. As such, it will be impossible for these originators to make any initial determination of whether the borrower is qualified, the borrower has been excluded from participating in a government loan program, or the property is unacceptable.

FHA loan correspondents have always played an important role in originating FHA loans, and we believe they can continue to play a critical role moving forward into a new era for FHA. NAMB largely supports the changes proposed by Commissioner Stevens, but believes that additional consumer protections should be put into place along with the proposed changes.

2. *Increased Net Worth Requirements for Mortgagees*

FHA proposes to increase the net worth requirement for approved mortgagees to meet industry standards. The current requirement is $250,000, and has not increased since 1993. The proposed initial increase would establish a new net worth requirement of $1,000,000. FHA believes these changes will help to ensure that their approved mortgagees are sufficiently capitalized to meet potential needs, thereby mitigating any losses that may result and decreasing risks to the FHA insurance fund.

FHA cites the recent rise in net worth requirements by Fannie Mae and Freddie Mac as reason to raise the net worth requirements for approved mortgagees. Although FHA proposes to delay instituting the net worth requirement for underwriting and servicing mortgagees for one year, it would likely still be very difficult for smaller lenders to move from a $250,000 net worth to $1,000,000 within the span of one year. Some have proposed an incremental increase to $500,000 in the first year, with subsequent increases to $1,000,000 over next several years. Another alterative would be to tier net worth requirements based on volume.

Concern over an increased net worth requirement is two-fold. First, it would tend to concentrate power and control in the hands of only the largest lenders. Under such a scenario, when a large entity fails, the resulting losses could severely destabilize the FHA insurance fund. Also, there is a real risk that providing the largest lenders with a virtual monopoly will result in higher costs and other adverse consequences for consumers. Second, net worth has been shown to evaporate in mere days, meaning the satisfaction of a net worth requirement, no matter how large, can create a false sense of security. To date, there has been no link made between loan quality or performance and net worth. Eliminating high-quality mortgagees simply on the basis of net worth could have an inverse effect and actually harm the quality of FHA loan production.

Instead of a mandate for a higher net worth requirement, NAMB suggests implementation of a recovery fund whereby every FHA approved mortgagee must contribute to such fund in order to originate, fund or service an FHA loan. Similar requirements are currently standard for any person that wants to become licensed in a state pursuant to the SAFE Act.

VIII. Additional Changes to FHA that NAMB Would Propose

1. Update the Neighborhood Watch Early Warning System

In order to monitor compliance, FHA instituted the Neighborhood Watch Early Warning System to identify mortgagees who have an unacceptable default rate. The Neighborhood Watch Early Warning System is triggered when a mortgagee's default rate exceeds mortgages originated within the preceding 24 months, exceeds 200 percent of the default and claim rate within the geographic area served by a HUD field office, and also exceeds the national default and claim rate. The name implies prompt recognition of high default rates. However, 24 months must elapse to achieve a true average. The mortgagee must be notified and has appeal rights. This process is often very slow, and the affected individuals move on to another mortgagee leaving the issue unsolved and the mortgagees unnamed. NAMB recommends that FHA update the Neighborhood Watch Early Warning System and expedite the recognition of high default rates.

2. Mortgagee Review Board

Default is only one indicator of mortgagee problems. Fraud, failure to comply with FHA guidelines and poor practices can create undetected problems as well. FHA is too often slow in identifying problems and the Mortgagee Review Board is slow to respond to them. Finally, the courts make it difficult for HUD to recover any losses and it can take years to complete the process. NAMB suggests that HUD put more resources toward improving the Mortgagee Review Board process and insuring its actions and judgments come to fruition.

3. FHA Resources

In order to increase efficiency and productivity, funding for HUD and the FHA program must increase. The FHA has too few employees reviewing new applicants. It can take up to 6 months to receive an answer back from the FHA as to the status of an application for approval as a mortgagee or loan correspondent. With the increase in volume of FHA loans, there is a clear need to increase funding for all areas relating to FHA, particularly including computerization, lender assessment, approval and enforcement. In addition, there is a need for better coordination between HUD and law enforcement, as well as increased enforcement of the Truth-in-Lending Act and the Real Estate Settlement Procedures Act.

4. FHA Loan Limits

FHA volume has increased in part due to the increase in FHA loan limits. As intended, the temporary increase in loan limits for FHA (and the GSEs) is having a significant impact in high cost areas, particularly in the California housing market.

It is critical that we keep affordable mortgage finance available at a time when the housing markets struggle to climb out of their greatest hole in more than 70 years. NAMB strongly supports permanently establishing FHA loan limits in high-cost areas at their current levels.

IX. Conclusion

NAMB and the mortgage professionals we represent are very interested in maintaining a strong, healthy and relevant FHA loan program. FHA has been an innovator as well as an engine driving the housing market in this country. Not since the Great Depression has FHA's role been so vital.

NAMB strongly believes that the efficiency and expertise of the mortgage broker industry remains critically important to the health and future prosperity of the FHA loan program. Mortgage brokers are the most efficient mortgage distribution channel and therefore should remain an integral part of any plans to reform the FHA program. Moreover, we have seen the damage done by the HVCC to the quality and costs of appraisals in the conventional mortgage market simply by excluding mortgage brokers from the process. We strongly believe that any further exclusion of mortgage brokers, as proposed in the new FHA guidelines, will very likely have an adverse effect on the viability of the program and ultimately raise costs for consumers.

Thank you for inviting NAMB to testify today and offer our perspective on "The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers." We are grateful for the many opportunities we have had to work with HUD and this Committee, and we look forward to continuing to build and strengthen these relationships as we tackle many of the issues discussed today.

What It Takes to be FHA Approved
By John Councilman, CMC, CRMS

There are a number of items to consider before applying to be an FHA approved Correspondent. (All brokers are called Correspondent Mortgagees in FHA language.) FHA mortgagee status is more than just being able to offer FHA loans. It is a structural change to the way most brokers operate their business. There is also a considerable financial commitment that will be there every year, not just for approval. The structural change makes the broker behave more like a larger business. This can be a good transition for many brokers, especially if they are considering mortgage banking.

The first thing a broker should do is find a wholesale lender who is willing to fund at least $1 million dollars or all of your production. Even your existing wholesalers will want you to sign an FHA addendum to your agreement and provide other documents. You will need to get an Application for Approval (Form 11701) from HUD's website. (www.**hudclips.org**/sub_nonhud/cgi/pdfforms/11701.pdf) This was form 92001 so don't be confused if you see an old list. There are a few basic requirements that you won't see on the form that must be dealt with. At least 50% of the company's revenue must come from mortgage services. If you plan to use the same company for real estate sales or title services, you may be faced with setting up a separate affiliated company. You cannot be a sole proprietorship. Certain LLCs and partnerships do not qualify and some S-Corporations have improper structure. FHA is looking for "...a permanent organization having succession." In other words, if you are a one person operation and you die, the business would stop. The best bet is to be a C-Corp. Your company name may not include "national," "Federal," or another restricted word unless you are a bank.

Be careful about becoming a "net branch." Theoretically, HUD does not prohibit branches where the manager is paid on a "net" basis. They do frown on branches that are not true branches under the full control of the mortgagee. Control and supervision of employees must include, at a minimum, regular and ongoing reviews of employee performance and of work performed. A mortgagee must pay all its own operating expenses. This includes expenses of its main and branch offices involved in originating or servicing any FHA insured mortgages. Operating expenses include, but are not limited to, equipment, furniture, office rent, overhead, employee compensation, and similar expenses.

At least one person in management must be a 40-hour per week, full-time employee and have 3 years experience in mortgage origination and supervision. Experience in real estate sales or brokerage does *not* qualify. HUD will look closely at resumes when a mortgagee applies for approval to see if management personnel have experience in the areas in which they will be performing duties. The main office must have at least 2 full-time employees and each branch must have one employee. No employee who originates or works on FHA loans may have other employment in mortgage lending, in real estate or another finance- related field. Direct endorsement underwriters are included in this provision. An underwriter may not work on a part-time basis for any other mortgagee, even underwriting conventional mortgage loans. An employee may not perform duties for any other business while working at their job with the mortgagee. Loan officers and managers may be paid on a commission or "net" basis but still must receive a W-2. HUD has clarified that an employee who is not involved in FHA loans is not required to meet any of these restrictions. Some clerical functions may be outsourced but the costs of the outsourcing may not be passed on to the borrower. The applicant must certify that neither it nor any of its officers, directors, or principals, has been denied an operating license or otherwise sanctioned by any licensing or regulatory body. If the company or any of the primary people in the company have had problems with a state or federal regulator, it must be documented and explained. If you have any problems with your state or federal regulators, don't expect to be approved by FHA. HUD will want proof of proper licensure in the states where you will do business.

An applicant applying for approval as a non-supervised mortgagee or a non-supervised loan correspondent must provide sufficient evidence that its facilities meet FHA requirements. The applicant must submit photographs of its facilities, including its entrance, with evidence of permanent identification to the public. The applicant must submit a floor plan, which may be hand-drawn. The applicant must also submit a certification, signed by a senior officer, that the facilities comply with FHA requirements. If your office is in your house, you must be zoned for it, have a sign, a separate entrance and be completely lockable from the residence. Even commercial offices must be segregated from other businesses in an office building. You must have private space for interviews and be certain you have your Fair Housing poster up. You must have toll-free telephone service to any area you serve outside your local calling area. These submissions are in lieu of an on-site visit by FHA to the mortgagee's office facilities; however, FHA may still conduct an on-site visit. Evidence of acceptable facilities is not required for branch offices.

A Correspondent applicant must order and pay for credit reports and submit the complete originals, with the application, directly to the Lender Approval and Recertification Division, HUD Headquarters. A tri-merged report must be provided for all 25% or greater owners. A commercial credit report or a Dun & Bradstreet report must be included on the applicant and any parent company. This is required even if the applicant is a start-up company. A written explanation must be submitted by the applicant for all negative items disclosed by any credit report.

One of the biggest problems for mortgage brokers is meeting the net worth requirements. The business entity (not the owner) must have a net worth of at least $63,000. HUD is very finicky about what they allow you to count in the net worth. You may not include notes from officers, goodwill, borrowed funds or items used for personal purposes. If you have branches, each branch adds $25,000 more to the net worth requirement up to $250,000. Of that net worth, 20% must be kept liquid, essentially, in your checking account. Lines of credit or even marketable mortgages are not considered liquid assets. You must maintain that net worth and liquidity all year long.

Each broker should consider the costs before applying. The application requires a $1,000 fee plus $300 more for each branch. Every year thereafter, the renewal fee is $500 and $200 additional for each branch. That is the small part of the overall costs. The major cost for most brokers is the audit. You can't just hire any CPA for your audit. Your CPA will have to have special courses in government auditing, continuing education in it and be peer reviewed. That eliminates about 90% of the CPAs in the phone book. A long distance audit, that is where the auditor doesn't physically come to your shop, may cost less than $5,000. A thorough onsite audit starts around $6,000 and often costs $12,000 to $15,000. It may seem like a no-brainer to use an offsite audit but you get what you pay for. You will spend a lot more time gathering materials and shipping them to the CPA. Full service accounting firms generally will only do onsite audits. I found that going from onsite audits for a number of years, then to an offsite audit for a year and then back to an onsite audit revealed the weaknesses of the offsite audit. I spent thousands of dollars documenting what the offsite auditor had done to get back to a tight audit. Small accounting firms aren't necessarily a bargain either. The larger onsite auditor usually packages consulting and an excellent tax preparation staff with the audit. I gained the few thousand in fees back with a dedicated expert tax department doing our corporate taxes. It was a good feeling when the IRS called for an onsite tax audit to have an expert there to work them. It also felt really great to get a "no change" IRS audit. The rigors of the FHA audit made the IRS audit really easy.

FHA audits are prepared according to Federal auditing standards. These standards are quite rigorous. You will not only need a check or credit card statement to prove you paid for something, you will need a specific receipt. Even if you keep every receipt, the auditor will ask at random for specific receipts that you will have to wade through that mountain of receipts to find. You learn to be better organized right away. They will pull your files and ask for the settlement sheets, copies of incoming checks, deposit logs, receipts for payments from the proceeds and review ECOA and Fair Housing information. If you are the kind of owner who never balances the checkbook, perhaps FHA is not for you.

Most brokers are used to keeping their books on a "cash basis." That means you write in your books when you get the money and when you pay for something. Cash accounting is not acceptable for Federal audits. You will need to practice "accrual basis accounting." That means money is considered for the books when the money is earned not when you receive it and debts are considered for the period covered, not when you pay them. That will send you scurrying for things like your insurance policies to see how much of the policy covers the current year and how much covers the next year or the previous year.

Government auditing requires a concept called "internal controls." In broker language, that means that various people in your organization check each other to make certain there is no hanky-panky. Ideally, one person should log in all incoming checks, the bookkeeper should itemize all checks deposited, label them on deposit slips and enter them in the correct category in your accounting software. Finally, the owner or manager will check the bookkeeper to make certain all monies are accurate and linked to the items in the file. Starting next year, the AICPA has new standards for government audits. The auditor, according to SAS 112, is not supposed to be the person who keeps you books but audits them. The ausitor will be required to perform "risk analysis." This will undoubtedly raise the price of the audit and your blood pressure as well. Your auditor will need to note areas where there is a lack of controls which could result in misstated financial statements. They will have to perform a pre-engagement risk analysis with initial planning. Then they will have to do specific risk analysis and detailed planning. Finally, they will have to develop steps that respond to the risk assessment. If that sounds like a lot of words that don't mean anything, you can be certain that it means a lot more work for your accountant that you will pay for.

Then there is payroll. FHA requires that all loan officers and staff be paid on a W-2 basis. If you have been paying on a 1099 basis, you may want to seriously consider getting a payroll company. For about $100 to $200 a month, life will become much easier. Don't expect your CPA to do a great job with this. I've tried it several times. Get the payroll company. You will sleep far better and your audit will be much easier not to mention you will save enough in state and federal penalties to pay for the payroll company. The state has no compunction about slapping you with a lien without ever going to court or padlocking your office if payroll is not to their liking.

FHA may choose to come to your business unannounced. They have the right to look at any FHA files which should be readily available. Usually, they will set a time for their audit. Nearly every mortgagee I have spoken to that has undergone an audit gets some negative finding. Most are merely corrective but FHA can impose sanctions and fines or even revoke your FHA approval. Brokers especially fear indemnification. At times, FHA has required mortgagees to sign indemnification agreements that require the mortgagee to reimburse HUD if they take a loss on a mortgage where some material violation of FHA guidelines has occurred. FHA freely admits that they are much more likely to audit mortgagees that have a higher default rate than mortgagees who have a low default rate. If your default rate exceeds 150 percent of the Field Office average for a year, you may lose your FHA approval.

To be FHA approved, you will need to develop a quality control plan. It may surprise you that sometimes companies are approved as a mortgagee when their quality control plan does not meet FHA requirements. This won't come to light until FHA comes to you to do an audit and you are cited for having an inadequate quality control program. You are supposed to maintain a QC program that meets FHA requirements. This requires periodic updates. Even if you have an adequate quality control plan, it is very difficult to follow it on every loan. FHA expects a quality control review to be performed on approximately 10% of your loan production within 90 days of closing. It can be performed internally. However, I strongly recommend it be done by a good outside company. They will also help you to maintain a compliant quality control plan.

Becoming an FHA mortgagee does not give a company the right to use a government seal. Mortgagees are also prohibited from implying that an advertisement is from or endorsed by FHA or HUD. I have seen a mailer stating "This is an official notice…" HUD prohibits anything that simulates official notice from HUD. They can impose hefty fines or refer the case for criminal prosecution.

FHA is like a sleeping giant. Once you are approved, you may not hear from FHA for years if your audit is clean and your default rate is low. But, when FHA awakes, you do not want to be on the receiving end. As anyone knows, the government has endless lawyers and money. They can drive a small company into submission or into the ground in short order. If you make the commitment to become FHA approved, it will be an investment in accounting and in staff for many smaller companies. You must understand that your company is no longer just you. It has a life of its own. Many small companies find the rigidity and costs imposed on them unacceptable. At the moment, FHA is allowing non-approved individuals to be paid a "counseling" fee. The non-approved individual may not process the loan or be paid by the lender. They are not even allowed to take the loan application. HUD envisions them receiving a small fee. One should be careful in trying to earn the same fees or act in similar fashion to an FHA-approved loan correspondent.

Weigh the options carefully. If, after reading this article, FHA is for you, it can be quite profitable. But, be forewarned, it requires a new structure for most mortgage brokers.

John Councilman, CMC, CRMS is president of AMC Mortgage Corporation in Fallston, Maryland and chairs NAMB's Federal Housing Committee.

MORTGAGE BANKERS ASSOCIATION
Investing in communities

Testimony of David G. Kittle, CMB

Chairman

Mortgage Bankers Association

Before the

House Financial Services Subcommittee on

Housing and Community Opportunity

Hearing on

"The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers"

October 8, 2009

Chairwoman Waters, Ranking Member Capito, and members of the subcommittee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA)[1] on the future of the Federal Housing Administration's (FHA) capital reserves. I am David Kittle, Executive Vice President of Vision Mortgage Capital in Philadelphia, Pennsylvania, and MBA's Chairman.

I have been in the mortgage business and working with FHA insured loans since 1978. In 1983, 90 percent of the loans I closed as a loan officer were FHA loans (320 out of 343 loans made that year). From 1994 through 1999, FHA loans were about 38 percent of my company's business. I even financed my first home with an FHA mortgage. Over the last decade, prior to the current market crisis, FHA's prominence in and usefulness to the market dropped precipitously. As I will discuss, that is no longer the case today and is not likely to be the case going forward, and I commend the subcommittee for holding this important oversight hearing.

FHA is especially important to segments of the population who have needed a little extra help to achieve the dream of homeownership. More than any other nationally available program, FHA focuses on the needs of first-time, minority, and low-and moderate-income borrowers. According to recent data provided by the Department of Housing and Urban Development (HUD), both first-time homebuyers and minorities continue to make up a significant portion of FHA's customer base. For example, as of August 2009, approximately 78 percent of FHA-insured home purchase loans were made to first-time homebuyers, and 30 percent were to minorities. Minorities also comprise a higher percentage of FHA borrowers than they do the conventional mortgage market.

MBA has always advocated for a strong and vibrant FHA. We have been calling for updates to FHA's scope and operations since well before the current market disruptions reestablished FHA's prominence as a catalyst for bringing liquidity to the housing finance system. With the increased growth of FHA, it is imperative that we move swiftly and take appropriate measures now to protect the safety and soundness of the agency. This requires a multifaceted approach: ensuring that FHA has the right resources; requiring high standards of mortgage bankers and mortgage brokers; creating credit policies that are prudent, but aligned with the mission of FHA; and ensuring that FHA is helping to provide market liquidity during a time of crisis. In support of these goals, we recommend measures such as, raising net work requirements for FHA-approved lenders and correspondents, permanently increasing the FHA loan limits, extending and

[1]The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

raising the homebuyer tax credit, and establishing sensible consumer and lender protections for Home Equity Conversion Mortgages (HECM) borrowers. MBA believes that these actions will not only help FHA face current market challenges, but also ensure the agency's future viability.

The Growth of FHA and the Status of the Mutual Mortgage Insurance Fund

The pace and magnitude of FHA's recent growth is further evidence of its significance to the nation's housing market. In fiscal year (FY) 2009, FHA insured 829,300 home purchase loans, compared to 490,974 in FY 2008. Considering that just three years ago, FHA's share of originations was a paltry three percent, its current market share, which is greater than 30 percent, is truly astounding. MBA cites the following as the primary reasons for this dramatic growth:

- FHA loans usually require lower down payments than loans purchased by secondary market participants such as the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac. The maximum loan to value (LTV) ratio for FHA-insured loans is 96.5 percent, compared to 95 percent for the GSEs.

- The Emergency Economic Stabilization Act of 2008 temporarily raised the FHA and GSE loan limits for much of the country, which made FHA a more viable option for many homebuyers. Those temporary loan limits were replaced by new loan limits included in the Housing and Economic Recovery Act of 2008 (HERA), which were later temporarily modified by the American Recovery and Reinvestment Act of 2009. These limits facilitated many more loan originations across a wider spectrum of home prices.

Prudence and sound risk management principles suggest that the substantial increase in FHA volume should be accompanied by an equally sizeable emphasis on quality controls. Heightened vigilance is also required to deter the unscrupulous brokers, lenders and borrowers who once plied their fraudulent trade in the subprime market from migrating to the FHA market.

FHA recently announced that its reserve account had dropped below its statutory two percent requirement. Although this account is a secondary account and FHA's primary account (which covers potential future losses on each book of business over its entire 30 years) is fully funded, the decrease has raised concerns about the stability of FHA. According to FHA, the agency's real combined capital reserve is $30 billion and exceeds a four percent capital ratio. MBA believes that the capitalization of the fund is adequate for now, but we believe it is important to institute operational and structural changes in order to secure FHA's future viability. FHA's recent decision to hire a Chief Credit Risk Officer for the first time in its 75-year history is a positive step in the direction of a comprehensive risk management framework, which MBA strongly supports.

It is also worthwhile to put the performance of FHA-insured loans into perspective. According to MBA's National Delinquency Survey for the second quarter of 2009, 13.7 percent of FHA loans were past due, and the number of FHA properties in foreclosure was 2.98 percent. During the previous decade, the FHA total past due rate has averaged about 11 percent. The increase to this point has been relatively modest, compared to other categories of loans, primarily because there has been such a large increase in the volume of FHA loans outstanding. MBA expects that FHA delinquency and foreclosure rates will increase as these loans mature. The factors driving the increase are the macroeconomic conditions that are impacting all loans – such as the continued declines in home prices, continued increase in unemployment rates and continued weak housing demand, which inhibits the ability of delinquent borrowers to sell their home.

Resources Necessary for Improved FHA Operations

MBA believes a critical requirement for achieving, sustaining and protecting the housing market's long-term vigor is ensuring that FHA has the resources it needs to operate in a high-tech real estate finance industry. FHA's staff levels have remained virtually unchanged even though its market share has risen from three to over 30 percent. This ratio of activity to resources is unsustainable because it stretches FHA beyond its capacity. MBA strongly supports H.R. 3146, the 21st Century FHA Housing Act, which would provide FHA with up to $72 million in funding to hire additional staff and upgrade compensation to be commensurate with that of other federal financial regulators. The bill also permits funding to upgrade technology. Modernized technology would enable FHA to better monitor lenders, protect against fraud, and generally be better equipped to handle the challenges of a modern marketplace.

MBA is grateful that Congress authorized $25 million in HERA to be allocated each year to FHA for improving staffing and technology. The Omnibus Appropriations Act of 2009[2] made $4 million available for FY 2009 and FY 2010 to be used "for planning, modernizing, improving and maintaining information technology applications and infrastructure supporting FHA." While this funding is appreciated, it is not nearly enough to address FHA's growing needs. We urge Congress to provide the full $25 million each fiscal year though 2013, as authorized under HERA. Furthermore, as in H.R. 3146, FHA should be given the statutory authority to use its future revenues to make additional technology upgrades as needed. Ensuring these resources are available to FHA not only helps support the viability of its products and services but it also protects the Mutual Mortgage Insurance Fund.

Recent FHA Credit Policy Changes

Given the growth in its market share, and the potential risk to its finances, it was prudent for Commissioner Stevens to make recent policy changes to the FHA program. MBA

[2] Pub. L. 111-8 (March 10, 2009).

supports the direction of these changes and expects to work closely with FHA to implement additional adjustments that will help put the agency on stronger financial footing.

Appraisals

As MBA stated in previous testimony, reliable and accurate collateral valuations are important tools to help FHA, lenders, and investors estimate their risk of loss in a home purchase or refinance transaction. Determining a property's value is not an exact science, and is even more difficult in markets where home prices are volatile or declining. As a method of promoting reliable and accurate appraisal practices, FHA-approved lenders are required to use FHA-approved appraisers.

MBA members continue to express concern regarding the ambiguity of various terms of the GSE Home Valuation Code of Conduct (HVCC), and we have undertaken several initiatives to obtain clarifying interpretations from the drafting parties: the GSEs, Federal Housing Finance Agency and New York Attorney General. We understand the guidance recently issued by FHA was an attempt to refine several of the more contentious HVCC terms such as permissible communications with appraisers and appraisal portability. MBA appreciates FHA's proactive attempt to add the agency's perspective in these areas. We also recognize that the HVCC is just one component of the supervisory framework governing appraisal practices, which also includes the Uniform Standards of Professional Appraisal Practices (USPAP) and other interagency guidance of the federal financial institution regulators. We are committed to working with all of these regulatory bodies to ensure that property valuations are reliably prepared by qualified professionals in an environment free from coercion.

Revised Streamline Refinance Transactions

FHA's refinance transactions are meant to allow borrowers to pay off an existing loan and refinance into one that offers a better financial option. Recently, some borrowers have been using streamline refinances as a loss mitigation tool, which is an improper use of the product. MBA supports the direction of the changes that FHA made to its streamline refinance program. Verifying documentation, determining net tangible benefit, and obtaining credit scores, when available, are all sound underwriting practices that MBA supports.

Net Worth Requirements and Modification of Mortgagee Approval Process

As a government housing finance program, FHA deserves, and borrowers should expect, exceptional quality standards. Because FHA-approved lenders and correspondents are the primary, and oftentimes the only, contact for most borrowers, MBA believes they should be held to the highest levels of accountability, knowledge and professionalism. For these reasons, MBA recommends raising FHA's existing qualification standards.

MBA believes one area where FHA should consider enhancing its quality controls is by setting higher net worth and bonding requirements for single-family mortgage correspondents and bankers to participate in the program. Net worth requirements enable lenders and correspondents to be held accountable for their actions, and provide tangible evidence of their "skin in the game."

Currently, FHA requires mortgagees (mortgage bankers) to have a minimum net worth of $250,000 in order to be qualified to underwrite FHA loans. Correspondents (mortgage brokers) must have a net worth of $63,000. MBA recognizes that differences in net worth and bonding requirements for mortgagees and correspondents are based on the principle that mortgagees have greater responsibilities to the public and investors. MBA believes, however, these standards should be increased to hold both groups to greater levels of accountability.

Specifically, MBA believes mortgage bankers should have a minimum corporate net worth of the greater of $500,000 or one percent of FHA loan volume up to a maximum of $1.5 million. Mortgage brokers should have a minimum corporate net worth requirement of the greater of $150,000 or 0.5 percent of FHA loan volume up to the minimum mortgage banker status (currently $250,000 unless it is increased to the $500,000 level recommended by MBA). Also, mortgage bankers and brokers should maintain a bond where required. The amount of the bond should be sufficient to provide reasonable protection to consumers and others.

FHA is proposing to modify the mortgagee approval process, thus eliminating the requirement for loan correspondents to receive independent FHA approval for origination eligibility. The FHA-approved mortgagee would then assume the responsibility and liability for the loans underwritten and closed by the broker. According to the FHA, this policy change is necessary because the agency does not have the resources to effectively manage and monitor the broker community. The shift in responsibility also aligns its policies with those of the GSEs. MBA agrees that FHA staff is stretched thin and requires additional resources to develop and implement quality control mechanisms, but eliminating the current broker requirements may not be the best solution. As this change must be done through the rulemaking process, MBA will provide extensive comments once the details of HUD's proposal are known.

HUD's Implementation of the S.A.F.E. Act

In response to the subcommittee's question, MBA is not certain how effective HUD's implementation of the Secure and Fair Enforcement for Mortgage Licensing Act (S.A.F.E. Act) has been at tracking and screening out unscrupulous originators.

MBA supported the establishment of a registry to track and ultimately weed out unscrupulous mortgage brokers and other loan officers. Bad actors not only present risks to FHA, but they are a stain on our industry and must be removed.

HUD's recent activity in implementing the S.A.F.E. Act, however, may divert HUD from the important task of ferreting out bad actors and could jeopardize the ability of the industry to keep borrowers in their homes when they are having difficulties keeping up with their mortgages.

Under the S.A.F.E. Act, signed into law July 30, 2008, states were required to enact licensing and registration laws for state-regulated mortgage originators by July 31, 2009 (or by next year if their legislatures meet biennially). On a parallel track, federal regulators are required to promulgate rules requiring federally-regulated depositories to register their employees in the National Mortgage Licensing System and Registry (NMLSR).

HUD's role is to determine whether state laws meet the S.A.F.E. Act's education, testing, license renewal and other qualification requirements. Where a state does not meet these requirements or fails to pass a law by the national deadline, HUD is charged with imposing its own licensing requirements consistent with the purposes of the statute. Considering HUD's pivotal role, the states have been looking to HUD as they enact their own laws. It is therefore imperative that HUD carry out its functions carefully and judiciously.

Regrettably, earlier this year HUD opined through a set of frequently asked questions (FAQs), *without inviting comment from the public or affected industries,* on several key issues. In its FAQs, HUD stated it was:

> "generally inclined to provide in rulemaking that the SAFE Act's definition of a loan originator covers an individual who performs a residential mortgage loan modification that involves offering or negotiating of loan terms that are materially different from the original loan, and that such individuals are subject to the licensing and registration requirements of the SAFE Act."[3]

MBA and other trade associations strongly disagree with this interpretation. In a letter to HUD in March, we provided detailed views that the S.A.F.E. Act was never intended to cover servicers and the plain language of the statute did not support such an interpretation. Most importantly, by forcing the training, qualification, licensing and registration of loan servicers under the S.A.F.E. Act, while considering the difficulties borrowers are facing today, this interpretation risks greatly increasing the costs and slowing the process of borrower relief, which is contrary to the enormous efforts of the administration, Congress, and our industry.

It is notable that in carrying out their registry responsibilities, other federal financial regulators have not adopted HUD's interpretation and instead have invited comment on this important issue through a proposed rule.

[3] HUD FAQ 5, Issuance Date Unknown

This past week, industry representatives met with the Office of Management and Budget (OMB) and HUD staff after learning that HUD's proposed rule implementing its S.A.F.E. Act responsibility was pending OMB review. The industry had anticipated that the proposal would include the interpretations in the FAQs. MBA and other trade associations requested that HUD withdraw the FAQs and address the servicer matter and other key issues with appropriate notice and public comment in accordance with the Administrative Procedures Act. We also asked that HUD follow the Administrative Procedures Act and consult with stakeholders going forward. While some states apparently acted on the strength of the FAQs and have not excluded servicers, others have excluded them or are silent on the point and await HUD's final review.

In sum, MBA believes that rather than engaging issues that are beyond HUD's responsibilities, or beyond the scope of the law, HUD's efforts should be directed to facilitating efforts to root out bad actors in the origination process for the benefit of FHA and the wider mortgage market. MBA will continue to work with HUD and the Financial Services Committee to help the S.A.F.E. Act achieve its important purpose.

Permanently Increase the FHA Loan Limits

As mentioned earlier, MBA believes that FHA's growth is partly due to the temporary increase in its loan limits for the single-family programs. The single-family loan limit for FHA varies throughout the nation according to home prices, ranging from $271,050 to $729,750. These higher loan limits will expire on December 31, 2009, when the limit in high-cost areas will drop to $417,000.

Currently, FHA, Ginnie Mae and the GSEs are the only significant sources of housing finance liquidity. MBA believes it is imperative for these entities to provide secondary market support to the broadest spectrum of home prices possible during this period of market instability and beyond. Therefore, MBA encourages Congress to establish a permanent FHA single-family loan limit of $625,500 and up to $729,750 in high-cost areas. We urge Congress to act on this issue soon as the current loan limits expire at the end of this year and loans are already in the pipeline for 2010.

Extending and Expanding the Tax Credit

The dramatic fall in home values over the past couple of years has been caused by one primary factor: an oversupply of housing. To address this, Congress created an $8,000 tax credit for new home buyers. This credit, along with lower mortgage rates, has helped to moderate the decline in home prices by stimulating demand. As many as 350,000 sales so far this year could be directly attributable to the tax credit, according to the National Association of Realtors. First-time buyers, who have been on the sideline, are taking advantage of the credit and are buying again, cutting into that oversupply of housing and buoying home values.

Allowing the credit to expire would put in jeopardy the recent signs of recovery we are beginning to see in the housing market. Congress should act quickly in order to avoid a potential rush of borrowers overwhelming lenders and settlement service vendors by demanding to close before the tax credit expires on November 30, 2009.

In fact, not only should the credit be extended, it should be expanded. Congress should extend it to all home buyers and increase the credit up to $15,000. In addition, Congress should make it available immediately, so that a borrower does not need to wait until his or her next tax return, but instead can use it to help make a downpayment on the house or pay closing costs.

Changes to the Single-Family Mortgage Insurance Program

There are several options to protecting the fund, including moving to a risk-based pricing structure, increasing the upfront premium, tightening credit guidelines, or a combination of these approaches. There are clearly pros and cons to each option. MBA would consider supporting any of these options or a combination thereof, depending on the details. Our members are in the process of developing policy recommendations that will help protect the fund and improve FHA programs for the future.

Home Equity Conversion Mortgage Program

Home Equity Conversion Mortgages (HECMs) are designed to help one of our most vulnerable populations, seniors, so it is critical that care be taken to prevent abuses. In an effort to be proactive in this area, MBA convened an executive level task force last year that created a reverse mortgage model bill for states. This model bill would protect both consumers and lenders and would offer a unified approach to these policies across states. Most of our recommendations were modeled after existing HECM policies. MBA is firm in its support for mandatory counseling for all reverse mortgage borrowers, as well as preventing cross-selling as a condition for receiving a reverse mortgage. We also tackle the sensitive issue of borrowers not paying their taxes and insurance by recommending a mandatory three-year escrow account for all reverse borrowers. This would ensure that no borrower would have his/her home foreclosed on for three years due to unpaid taxes or insurance.

This year, for the first time, FHA requested a subsidy of $798 million as part of the President's FY 2010 budget, to cover losses that might be incurred over the life of the loans originated in FY 2010. The House's version of the appropriations bill did not include any subsidy, while the Senate's version only included a subsidy of $288 million. These two bills are currently in conference. The result was that FHA needed to re-evaluate the HECM program. This evaluation led to the recently-announced change to the principal limit factors that became effective October 1, 2009. This change resulted in a 10 percent reduction to the principal limit. Although MBA understands the business rationale for this change from a risk perspective, it is critical to note that it is the consumers who are being negatively impacted because they are receiving lower proceeds for the same cost. MBA also objects to the short implementation time for such a significant policy change.

Some of the other choices for addressing the HECM shortfall include Congress appropriating a subsidy, FHA changing the upfront premium, or FHA reducing the HECM loan limit. MBA does not support a reduction in the existing loan limit. We are working with FHA and other industry groups to recommend a long-term solution that would keep the HECM program self-sustaining.

<u>FHA Multifamily Programs</u>

With all the focus on the residential real estate market, MBA must point out the continued – and even expanded – importance of FHA's multifamily programs in today's housing market.

During the current market downturn, affordable rental housing becomes a more urgent need for families and elderly individuals who either cannot afford to buy or who chose to rent. With the collapse of the commercial mortgage backed securities market, FHA is experiencing a significant increase in volume in its multifamily and healthcare programs. During FY 2008, FHA issued commitments for $3.6 billion in multifamily/healthcare mortgages. In FY 2009, FHA issued commitments for $5.5 billion – a more than 50 percent increase. And these numbers do not reflect substantial waiting lists for applications to be reviewed by FHA staff.

FHA's multifamily and healthcare programs are extremely staff-intensive, as each application must be thoroughly reviewed and approved by FHA staff prior to the issuance of a commitment. The need for additional staff and enhanced technology are as critical for these programs as they are for the single family programs.

MBA also wants to commend the Financial Services Committee for passing H.R. 3527, the FHA Multifamily Loan Limit Adjustment Act, through the House last month. While FHA's multifamily loan limits are sufficiently high in most markets, in some areas of the country they are severely restricting the ability to use FHA insurance programs to finance rental housing. H.R. 3527 will increase the loan limits for elevator buildings and provide the HUD Secretary with additional discretion in extremely high cost areas (similar to that provided in Alaska and Hawaii today).

<u>Conclusion</u>

Thank you for the opportunity to testify. MBA appreciates all that FHA is doing to provide stability, liquidity and affordability during this difficult time in the housing finance market. As I have stated, now is the time for Congress and the mortgage industry to support the agency in order to protect the safety and soundness of the agency. MBA stands ready to work with Congress to enhance and sustain FHA now and in the future.

Testimony of

Patrick Newport

U.S. Economist, Director of Macroeconomic Forecasting
IHS Global Insight

October 8, 2009

Subcommittee on

Housing and Community Opportunity
House Financial Services Committee

My name is Patrick Newport. I am the Director of long-term forecasting at IHS Global Insight, an economic forecasting and consulting company based in Lexington, Massachusetts.

I have been with IHS Global Insight since 1998 and am part of the U.S. Macroeconomic Service, where I cover the national housing market.

I have a Ph.D in Economics from Harvard University and an undergraduate degree from Louisiana State University.

Thank you for inviting us to this hearing.

I have been asked to discuss IHS Global Insight's U.S. housing outlook, with a focus on housing prices and the tax credit for first-time homebuyers.

I want to start by discussing housing prices.

According to a number of measures, housing prices are stabilizing. They are stabilizing nationally and across most large cities. They are stabilizing across the world.

You can see this in the first chart, which tracks the Federal Housing Finance Agency's (FHFA) seasonally adjusted purchase-only house price index (HPI) at a monthly interval.

Over the period from 2000 through 2006, inflation-adjusted housing prices rose about 33%, peaking in March 2006. Since then, real prices have dropped 14% and are now about 13% above their average value in 2000.

Nominal housing prices-which are not adjusted for inflation-rose 63% over the same period (2000-06), and have since dropped about 11% from their peak. The FHFA HPI bottomed out in April 2009, and has risen now for three straight months.

A second measure of house prices, the Case-Shiller house price indices, is showing a similar pattern. In July, seasonally adjusted prices increased in 17 of the 20 cities that Case-Shiller covers. Nine cities saw prices rise for the third straight month. Las Vegas was the only city reporting a steep decline.

The key reason for this recent stabilization, which I would characterize as occurring much sooner than expected, is the decline in long-term interest rates.

My third chart plots the yield on the 10-year Treasury note, which, as you can see, is near its lowest level since 1960. The fourth chart tracks long-term fixed mortgage rates, which are also now near historical lows.

There are more reasons that prices are stabilizing. One is that prices have fallen so far that, by some yardsticks, they are below their long-run equilibrium value.

A third reason is the tax credit for first-time homebuyers, which has stimulated demand. I would like to briefly discuss this factor because it plays an important role in IHS Global Insight's housing outlook for 2009 and 2010.

According to recent surveys of real estate agents by Campbell Surveys, about 1.6 million of the 3.9 million homes sold through mid-September went to first-time homebuyers. If one extrapolates these numbers, first-time homebuyers will total about two million in 2009. About 400,000 of these, according to the survey's methodology, will be incremental buyers-that is, buyers who would not have bought a home this year without the tax credit.

The impact of the tax credit, thus, is not trivial.

The main effect of the tax credit is to shift demand from 2010 into 2009. Therefore, once the tax credit expires, demand will take a hit-home sales will drop-and house prices will resume their downward course, depressed by the weight of rising foreclosures and rising unemployment rates. Our view is that home prices will drop another 5% from current levels, hitting bottom in 2010.

My fifth chart is our forecast for home sales. You can see that the pace has accelerated since bottoming out in the first quarter of this year, and we expect it to reach about a six-million-unit annualized pace in the fourth quarter of 2009. The drop seen in 2010 is the result of the tax credit expiring. We expect sales to tail off to about 5.5 million units in 2010.

Although we do see bond yields heading substantially higher over the long term, it is too early for a major bear market to begin, since we judge the economy as too weak and inflation as too distant a threat. Markets appear to have taken the same view, and yields are now below 3.5%. We expect them to remain below 4.0% in 2010 and most of 2011.

Our forecast assumes that the first-time homebuyers' tax credit is neither extended nor expanded.

Let me stress that IHS Global Insight does not take a position on whether the tax credit should be extended or expanded. We have clients on both sides of this and most other issues. Indeed, our forecast assumptions are based on current law.

Again, thank you for inviting me. I am prepared to answer all questions about IHS Global Insight's U.S. economic outlook.

Chart 1

Housing Prices Are Stabilizing...

(FHFA Purchase-Only House Price Index, Jan 2000 = 1.0)

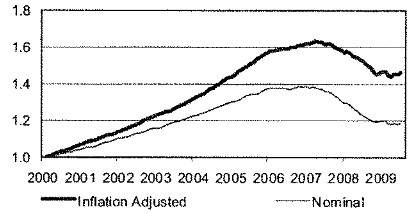


Chart 2

...But Will Decline Further

(FHFA Purchase-Only House Price Index, 2000:1 = 1.0)

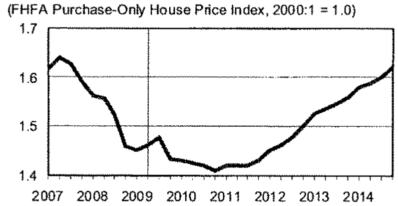


Chart 3

Long-Term Interest Rates Near 50-Year Lows

(Yield on 10-year Treasury notes, percent)

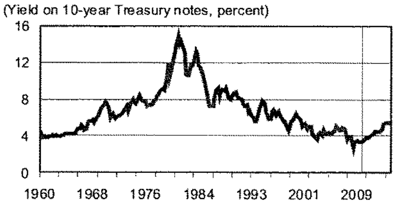


Chart 4

Mortgage Rates Are Also Down

(Commitment rate on conventional 30-year mortgage, percent)

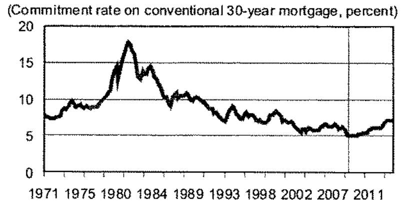


Chart 5

New and Existing Home Sales

(Million units, annual rate)

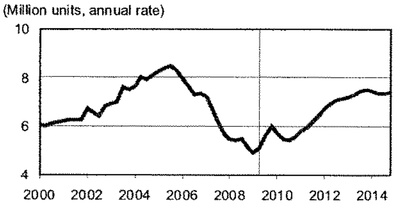


Chart 6

Mortgage Delinquency and Unemployment

(Percent)

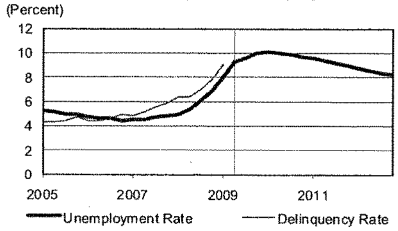
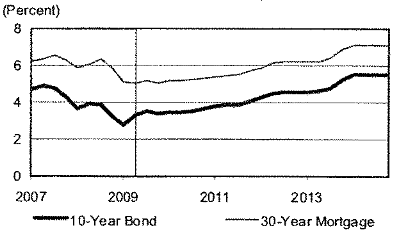


Chart 7

Interest Rates Will Climb Slowly

(Percent)



Statement of

Edward J Pinto

Before the Subcommittee on Housing and Community Opportunity of the Financial Services Committee

United States House of Representatives

October 8, 2009

Hearing before US House of Representatives Housing and Community Opportunity Subcommittee – October 8, 2009

Submitted testimony by Edward Pinto, real estate financial services consultant, former chief credit officer of Fannie Mae (1987-1989), and expert in sustainable affordable housing programs

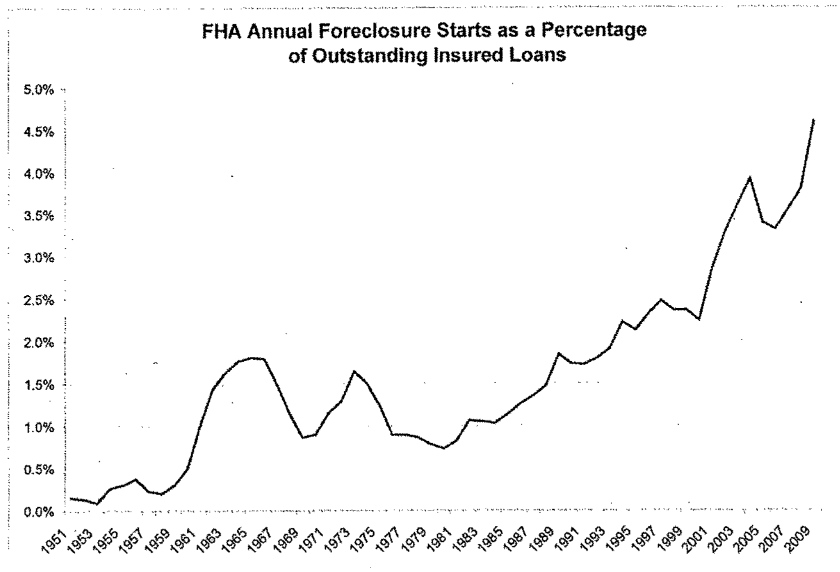
Chairman Waters and Ranking Member Capito, thank you for the opportunity to testify today. I am an expert in the field of affordable lending, having 15 years experience both on the state and national level. I have designed and implemented sustainable affordable housing programs. I am also an expert in credit risk methodologies and loan performance metrics. I was Fannie Mae's chief credit officer from 1987 to 1989. Since leaving Fannie, I have consulted extensively on loan performance risk characteristics.

My purpose in testifying today is to advise you of the growing fiscal crisis facing the Federal Housing Administration (the FHA). Many witnesses over the years have made repeated warnings to this and other congressional committees. By my testifying today, this subcommittee will not be able to say that no one told them of the magnitude of the impending losses at FHA.

<u>A. FHA's experience over 65+ years:</u>

FHA's annual percentage of new foreclosure starts has steadily increased over the last 60 years, from 0.15% in 1951 to 2.36% in 1998 to an estimated 4.4% in 2009.

CHART 1



Sources: FDIC, MBA, and Edward Pinto

I fear that this trend will continue as the millions of recently insured high risk loans become seasoned and start foreclosing in much greater numbers. Ultimately this trend is unsustainable. There is no amount of insurance premium that is sufficient to cover the losses incurred by deliberately insuring loans based on poor underwriting standards.

Before continuing on about the problems facing FHA, I must tell you that FHA's high risk lending practices negatively impact the entire housing finance marketplace and the neighborhoods in all of your districts. I have included as attachments research by the FDIC (Attachment #1: *The Rising Long-Term Trend of Single-Family Mortgage Foreclosure Rates* (1998)), Fannie Mae Foundation (Attachment #2: *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values* (2006)), and The Federal Reserve Bank of New York (Attachment #3: *Examining the Rising Foreclosure Rate* (2003)). Please note that these papers (or the research upon which they are based) pre-date the so called

subprime crisis of 2004-2006. Please keep Chart 1 in mind as you read these articles.

B. Factors driving the likelihood of a bailout:

Back to FHA – I believe it appears destined for a taxpayer bailout in the next 24 – 36 months. There are five drivers supporting my conclusion:

1. **FHA risks being adversely selected:** This is a risk facing both the FHA and the Veterans Administration (VA) as they now account for over 90% of all the high LTV (>90% LTV) loans being made, most of which have an effective loan-to-value (LTV) in excess of 96%.
   - Adding to the risk of this high market share is the fact that insuring high LTV loans in a housing market where prices have yet to stabilize, poses a high risk of lending into a vacuum as other lenders have exited high LTV lending. This helps explain FHA's seven-fold increase in market share since 2006;
   - Total high LTV lending in the first half of 2009 was equal to 23% of all originations by all lenders. It was only 17% of originations in 2006, a year notorious for its high risk lending;
   - FHA allows up to 6% in seller concessions before requiring an appraisal adjustment. This amount is excessive and further distorts a loan's effective LTV. In 1985 Fannie Mae limited seller concessions on 95% loans to a maximum of 2% after finding that higher concessionary amounts greatly increased default risk;
   - The heavy use of the $8000 first-time homebuyer credit may result in price and other distortions that effectively eliminate FHA's protection from its small downpayment requirement. FHA's recent experience with another type of downpayment assistance program resulted in default levels 2-3 times normal. Eighty percent of FHA's purchase money loans are to first time homebuyers.

2. **FHA's dollar volume has exploded:** FHA's dollar volume in 2009 is running four times its volume in 2006. As a result FHA and VA loans will constitute about 10% of all outstanding first mortgages by year end 2009, with about half of these made since year end 2006.
   - Millions of new ultra-low downpayment loans are being added to a housing finance marketplace that is already a sea of borrowers with low equity or negative equity; and
   - At the end of Q.1:09, the average equity of all 53 million homeowners with a mortgage was only 10%, the lowest level in our history;
3. **FHA is making much larger loans than it has in the past:** Its top dollar limit is now $729,750 versus its old top of $362,000 in 2008. This is both a new price segment and involves new areas of the country such as California. Wells Fargo and Bank of America are the two largest FHA lenders with a combined share of 46%. On a combined basis these two lenders have seen their California FHA loan volume increase from 3% of loan volume two years ago to 10% of loans today. This higher end of the market will likely come under increasing stress as foreclosures continue to increase in this segment;
4. **Higher FICOs are not a panacea:** FHA's FICO score has increased from an average of 631 (FY 2007) to an average 672 (FY to date 2009), an increase of 41 points. In August 2009 the average was 692 evidencing an increase of 61 over the FY 2007 average (source: FHA Outlook http://www.hud.gov/offices/hsg/comp/rpts/ooe/olcurr.pdf). It is troubling that FHA's FICO average in August 2009 about equals Fannie Mae's FICO average of 695 on its portfolio of loans with downpayments of 5% or less, a portfolio that is performing quite poorly[1], as will be noted in greater detail below.

[1] http://www.fanniemae.com/ir/pdf/sec/2009/q2credit_summary.pdf;jsessionid=T4PT1BI1ACGWXJ2FQSISFGA

Also troubling is the fact that the Fair Isaac Corporation (the producer of FICO scores) reports that a 690 FICO score on a mortgage originated in October 2008 performs like a 645 FICO score on a mortgage originated in October 2007 and a 630 FICO originated in 2005-2007[2]. As a result, on a FICO risk basis FHA's risk has not improved; and

5. **FHA has had a long history of fraud:** This history along with an inability to monitor, control, and discipline its lenders poses additional risks. FHA has added thousands of new lenders/correspondents over the last two years. By the time these lenders/correspondents demonstrate a track record, it may be too late.

C. FHA's early warning database indicates that loan performance is deteriorating:

The above observations are supported by a review of FHA's early warning database, which demonstrates that loan performance is deteriorating:

1. **FHA's early warning default rate (here defined as 90 days or more delinquent) on loans with at least ONE default within 24 months of origination continues to be about the same as three years ago, but with almost 3 times the volume (source: https://entp.hud.gov/sfnw/public/). Note: this rapid increase in volume understates the poor performance of the more recent loan cohorts due to a significant "denominator effect[3]":**

   FHA Loan Performance definition: total defaults (90 days or more delinquent) within the first two year of origination divided by total loans originated during the same two year period:
   As of 8.31.09: **5.73%** of 2.759 million loans endorsed within the prior 24 mo. had at least one default since origination.

   For the quarter ending 6.30.08: **4.68%** of 1.179 million loans endorsed within the prior 24 mo. had at least one default since origination.

   For the quarter ending 6.30.07: **4.94%** of 0.818 million loans endorsed within the

[2] See Attachments #4 and #5

[3] Mortgage default statistics are susceptible to the "denominator effect" when the denominator (representing volume) is growing at a faster pace than in the past, while the numerator (representing the development of an event such as a serious delinquency) is growing more slowly given that a new or unseasoned loan usually has a lower delinquency rate for the first 1-2 years after origination compared to its later years.

prior 24 mo. had at least one default since origination.

For the quarter ending 6.30.06: **5.80%** of 0.958 million loans endorsed within the prior 24 mo. had at least one default since origination.

This indicates that overall quality has not improved, but has in fact declined over the last 26 months.

2. **At the same time the early warning default rate (here defined as 90 days or more delinquent plus those loans that had already gone to claim) on loans in default as of the last day of the 8.31.09 reporting period has increased by 57% since three years ago (6.30.06), again with almost 3 times the volume:**

   As of 8.31.09: **4.82%** of 2.759 million loans endorsed within the prior 24 mo. were in default or had already gone to claim on the last day of the period.

   For the quarter ending 6.30.08: **3.48%** of 1.179 million loans endorsed within the prior 24 mo. were in default or had already gone to claim on the last day of the period.

   For the quarter ending 6.30.07: **3.22%** of 0.818 million loans endorsed within the prior 24 mo. were in default or had already gone to claim on the last day of the period.

   For the quarter ending 6.30.06: **3.07%** of 0.958 million loans endorsed within the prior 24 mo. were in default or had already gone to claim on the last day of the period.

3. **The above two data sets indicate that the non-cure rate has increased dramatically:**

   This conclusion is supported by comparing the non-cure rate for early warning defaults:

   2006: 50% of the loans originated during the 2 year period 7.1.04 -6.30.06 that suffered at least one default (90 days or more delinquent) during that period, were still delinquent or had gone to claim as of 6.30.06.

   2009: 81% of the loans originated during the 2 year period 9.1.07 -8.31.09 that suffered at least one default (90 days or more delinquent) during that period, were still delinquent or had gone to claim as of 6.30.09.

It is clear from the above that past tightening by FHA has had no effect. Further, the minor additional tightening announced on September 18, 2009, such as the increase in lender net worth, while long overdue, are at this point little more than Band-Aids. For the month of August 2009, just four lenders were responsible for over 85% of all FHA loans added. These four lenders are: Wells Fargo, Bank of America, Chase Home Finance, and CitiMortgage. Net worth is no longer the issue. The issue has moved on to the implications of having FHA's business concentrated among four lenders, lenders that are universally acknowledged to be "too big to fail".

FHA is an agency that is growing by leaps and bounds, with thousands of new lender and broker relationships, exposures to new risks, antiquated systems, high turnover, a history of fraud and escalating default rates, and a rapidly declining capital level.

D. Status of Reserve Funds:

FHA states that it has two reserve funds (Capital Reserve Account and Financing Account) that hold a combined $30 plus billion. This amount is designed to cover expected losses over the remaining term of its mortgage insurance book of risk-in-force. Putting aside the fact that this "money" is merely a bookkeeping entry at the U.S. Treasury and that much of it has been spent to reduce the federal deficit, I estimate that the losses imbedded in FHA's $725 billion in single-family risk-in-force is well in excess of $30 billion.

FHA's book is largely unseasoned, consists of high risk loans, and was originated under adverse circumstances. I believe that is reasonable to assume that FHA's book will perform similarly to Fannie Mae's 2006 high LTV book of business. I estimate Fannie's ultimate cumulative default rate on its 2006 high LTV book be about 20% of insured loans. Applying this default rate to FHA's current book of 5.8 million loans yields 1.2 million new foreclosures. Fannie is experiencing a loss rate per default of an estimated 50% of principal on its high LTV defaults. This would amount to total losses of 10% on its $725 billion book of insurance or $70-plus billion in losses. Based on my analysis FHA is short $40 billion in its Financing Account as of 9.30.09. Since this shortage would leave no reserves to cover its Capital Reserve account requirement of 2%, it would also be short the additional $14 billion necessary to meet this requirement. Please note: I assume the FY 2009 annual audit study will not project shortfalls of this magnitude because the assumptions used will be overly optimistic relative to loss mitigation resulting from both loan modifications and recent and expected underwriting changes.

E. Will FHA's loan modification program reduce its overall loses?

An issue related to any projection of ultimate losses is the eventual success of FHA's loan modification program. FHA has had a loan modification program since 1996. Over the last 13 years it has continually become more expansive and expensive. Yet it has failed over this period to stem the growing tide of foreclosures, as evidenced by Chart 1.
During Q.2:09 (as reported in the September 2009 OCC and OTS Mortgage Metrics Report) the FHA and VA modified 25,721 loans out of 4,778,162 loans reporting. FHA loans account for the overwhelming share of these loans. This yields a 2.1% (annualized) modification rate:

- **In 95% of the cases, overdue interest was added to the outstanding principal thereby increasing the loan-to-value and ultimately increasing risk;**
- **In 77% of the cases, the interest rate on the loan was reduced. FHA absorbs the cost of this rate reduction by way of a partial insurance claim;**
- **In 46% of the cases, the loan term is extended, thereby reducing near-term amortization and ultimately increasing risk; and**
- **After 12 months, FHA and VA modified loans are experiencing the highest 60+ day re- default rate of any loan type category, a rate of 59.1%.**

These statistics do not bode well for either the success of FHA's modification efforts or the goal of limiting FHA's ultimate losses.

Effective August 15, 2009 FHA announced its latest in a long series of modification programs, the FHA-Home Affordable Modification Program (FHA-HAMP). Based on FHA's dismal experience with its own loan modifications and the poor experience that the FDIC is having with IndyMac's similarly structured modification program[4], FHA-HAMP does not hold out much promise of reducing FHA's ultimate losses.

F. Outlook under current and proposed policies:

The combination of an increasing default rate, a soaring non-cure rate, and an extraordinarily high re-default rate on loan modifications is proof that FHA is merely postponing much of its expected losses, and is likely adding to its ultimate level of losses.

[4] I have been following the performance of IndyMac's "Mod in a Box" program since its inception in August 2008. Once again the publicly available data suffers from the denominator effect. After adjusting for this, the re-default rates continue to be unacceptably high. IndyMac is now called OneWest Bank.

Unfortunately FHA's past is destined to be its future. An insurer, even a government backed one, cannot lend on a high risk basis into markets with declining home values without getting excessively high rates of default along with soaring non-cure and re-default rates.

G. Proposals for ending FHA's nightmare of foreclosures:

1. Raise the minimum FHA downpayment on home purchase loans to 10%, with reduced seller concession amounts and tightening of other gimmicks that distort home values[5];
2. Limit FHA's volume of low downpayment loans to a 5% - 10% market share so as not to distort the housing market;
3. Reduce FHA's dollar limit back to a level commensurate with its low and moderate income housing mission; and
4. Require FHA lenders to have real skin in the game through a coinsurance requirement of perhaps 10%, backed by adequate capital requirements.

These steps will provide more consumer protection, reduce defaults to a more acceptable level, police FHA lenders and reduce fraud far more effectively than other suggested methods.

H. Conclusion:

FHA needs to take material steps now to protect taxpayers from another bailout. Failing to take action now will further increase FHA's and the taxpayers' losses.

[5] A major goal of single family AH is wealth building through homeownership and equity build-up. Clearly past efforts have not worked out well for many, if not most AH borrowers.

The lack of significant equity by large numbers of borrowers in neighborhoods is both a major cause and a continuing contributor to housing price instability. Real estate is fundamentally cyclical and borrowers (particularly those of low and moderate income) need staying power in the form of equity, fixed interest rates, good credit habits, and debt ratios that allow for some cushion.

A homeowner without the requisite 10% down would be encouraged to participate in a 5-year downpayment savings plan:

a. Establish a five year savings plan based on saving $25 - $35/week would be established. $6500 - $9100 would be saved over 5 years. Add in interest earnings at 3% and an employer match through a 401k or a foundation grant and the total grows to $15,000 - $20,000 at the end of 5 years, enough for a 10% downpayment on a home that sells for 80% of the median; and

b. At the end of five years, the prospective homeowner has accomplished much, having saved a substantial downpayment, established a banking relationship and savings pattern, hopefully established a solid credit history and is now in a position to buy a home. The bank holding the saving plan account would be a suitable lender.

Attachment #1

The Rising Long-Term Trend of Single-Family Mortgage Foreclosure Rates*

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Abstract

This paper identifies and analyzes the long-term rising trend in single-family mortgage foreclosure rates. Traditional measures of mortgage risk, such as house appreciation rates and loan-to-value ratios (LTVs), appear to explain some, but not all, of the long-term trend. In an effort to explain the remaining part of the trend, several non-traditional hypotheses are explored. One is the notion that the incidence of shocks to individual lifestyles or "trigger events," such as divorce, have increased, thereby increasing the likelihood of mortgage default. The second is that the risk posture of individuals has increased, especially as individuals increasingly leverage their homes as part of a broader strategy of managing their overall wealth portfolio. The third is the possibility that structural changes in servicing, arising from the trend toward securitization, have increased foreclosure rates. While evidence exists supporting these hypotheses, the risk posture hypothesis appears more consistent with a variety of disparate incentives and trends relating to household financial management.

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The Rising Long-Term Trend of Single-Family Mortgage Foreclosure Rates

The long-term trend in single-family mortgage foreclosure rates is rising. As shown in Figure 1, industry statistics produced by the Mortgage Bankers Association (MBA) and other sources suggest that foreclosure rates over the past decade are noticeably higher than rates experienced at any time in the past 50 years.[1] Moreover, the long-term trend, although rising gradually, translates into a dramatic increase in foreclosures over the course of a generation. The long-term trend is reflected in foreclosure rates both on mortgages insured by the Federal Housing Authority (FHA) and on conventional mortgages, i.e., those not insured by either the FHA or the Veterans Administration (VA).

During the 1950s foreclosure rates on conventional mortgages fluctuated within a narrow band, ranging from a low of 0.04 percent in 1953 to a high of 0.12 in 1959. These rates rose in the early 1960s, peaked at 0.78 percent in 1966, then declined in the late 1960s to the relatively low levels experienced throughout the 1970s. But between the early 1980s and the present, rates increased more than 300 percent, rising from 0.31 percent in 1980 to 1.04 percent in 1997. This represents an approximately ninefold increase since the early 1950s, with a threefold increase occurring after 1980. FHA foreclosure rates reflect a similar pattern, although these rates are currently approximately 11 times higher than the rates of the early 1950s.

The long-term foreclosure rate trend is surprising in the light of strong aggregate economic conditions experienced throughout most of the 1980s and 1990s. Although individuals who default commonly cite unemployment as the reason for their default, the rising trend has continued throughout extended economic expansion during the 1980s and the 1990s.[2] The experience of the 1990s is even

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[1] Construction of the long-term foreclosure rate series is described in the appendix.

[2] Gardner and Mills (1989) and Ambrose and Capone (1996) provide panel data on borrower motivations for default. Business cycle data from the National Bureau of Economic Research (NBER) record the 1980s expansion as lasting 91 months and the 1990s expansion as 86 months as of May 1998. These expansions rank as the second and third longest since NBER records began in 1921.

more remarkable, given that declining unemployment and continuing economic prosperity have been accompanied by relatively stable prices.[3]

This study examines the rising aggregate trend of mortgage foreclosure rates with an eye toward exploring the roles of traditional determinants of mortgage default alongside nontraditional measures relating to household risk. Section I reviews several of the most widely recognized determinants of mortgage default and examines their relationships to the aggregate trend. Section II describes aggregate movements of individual financial shocks, or "trigger events," that might correlate with the long-term trend. Section III extends the discussion to variables relating to household risk posture and their relationship to the trend. Section IV examines the growth in third-party servicing that has accompanied the trend toward securitization. Section V tests the empirical content of traditional versus nontraditional variables for explaining the long-term trend. Section VI summarizes the results and concludes.

I. Traditional Measures of Mortgage Risk

Determinants of mortgage default have been studied for many years and have been widely tested with respect to their ability to explain default at the level of the individual loan, city, state, and region.[4] The interesting question is, do previously identified determinants of default explain the rising long-term aggregate trend?

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[3] As is discussed below, house appreciation rates have remained in the 2–6 percent range for most indexes and in most years following 1982.

[4] All studies confirm the importance of homeowner equity, with most also finding a role for shocks to borrower income, such as loss of employment or divorce. Recent academic work along these lines includes Quigley and Van Order (1995), Phillips, Rosenblatt and Vanderhoff (1996), Case and Shiller (1996), Deng (1997), and Capozza, Kazarian, and Thompson (1997). Rating agency and other practitioner research, such as Wilson (1995), Jones et al. (1995), and Monsen (1996), tend to take a broader perspective that includes mortgage type, credit, or other effects alongside those emphasized by academic research.

As noted above, it is natural to expect unemployment rates to explain the foreclosure rate trend. However, the opposite is actually observed. As can be seen in Figure 2, unemployment rates exhibit the anticipated upward "spike" at each of the eight recessions, over the past 50 years, and decline during the nine expansions. Nevertheless, the long-term trend in unemployment rates bears at best a weak relation to that of foreclosure rates. While unemployment rates tended to be higher between the mid-1970s and the mid-1980s, they began declining in 1984 and, by 1995, had returned to levels found in the early 1970s and other previous periods. Moreover, foreclosure rates only occasionally contain the recession "spike" regularly observed in unemployment rates.

A second seemingly unrelated variable is nominal interest rates. Academic models emphasizing the option-like characteristics of mortgage default often stress that declining (rising) interest rates should provide a strong incentive to default (not default), especially in areas characterized by weak or declining (rising) house prices.[5] Unfortunately, interest rate movements over the past 35 years fail to reflect a consistent inverse or negative relationship between changes in interest rates and mortgage foreclosure rates (see Figure 2). Indeed, prior to the early 1980s the relationship appears to be positive, with almost no relationship observed during the "hump" in foreclosure rates in the mid-1960s. More recently, two periods of sharply declining rates, 1985–86 and 1991–93, are closely associated with record mortgage prepayments, but are not closely related to spikes in foreclosure rates (e.g., foreclosure rates increased slightly in the 1986–87 period and declined in 1992–93).

All theories of mortgage default stress a key role for homeowner equity, and empirical analysis supports this emphasis. Since the most direct measure of equity is the loan-to-value ratio (LTV), we expect to observe a strong positive relationship between LTVs and foreclosure rates, although the

[5] A sample of literature relating to treatment of mortgage default as an option can be found in Hendershott and Van Order (1987), Kau and Keenan (1995), and Vandell (1995). Several recent

relationship may not surface until several years after mortgage origination. As Figure 3 illustrates, rising LTVs explain several, but not all, aspects of the foreclosure rate trend. In the early 1950s mortgage lending was remarkably conservative, as witnessed by an average LTV of only 58 percent in 1952. Rising LTVs throughout the 1950s suggest a transition to modern-era lending practices, when LTVs have averaged over 70 percent. This transition explains the exceptionally low default rates of the 1950s as well as rising rates in the early 1960s. Unfortunately, LTV trends fail to track foreclosure rates for the two decades after the mid-1960s. A possible relation reappears in the late 1980s and 1990s, as slowly rising LTVs again follow rising foreclosure rates. However, this most recent relationship is questionable because of the close relationship between conventional and FHA rate trends, as noted in Figure 1. That is, since FHA mortgages have had high LTVs for many years, and the FHA patterns in Figure 1 are very similar to conventional patterns, it seems unlikely that rising LTVs are solely responsible for the rising long-term trend in mortgage foreclosure rates.

A second variable that affects homeowner equity is the rate of appreciation in house prices. High home appreciation expedites the buildup of equity by reducing the current LTV, i.e., loan to current value. Other variables being equal, high home appreciation is expected to reduce defaults as current LTVs decline and wealth increases.[6] As shown in Figure 4, two indexes of house appreciation increased in the late 1960s, remained high until the early 1980s, then dropped to much lower levels until the present time.[7] These trends suggest that house appreciation is especially useful in explaining the

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alternatives to the option model include Elmer (1997), Archer, Ling, and McGill (1996), or Yang, Buist, and Megbolugbe (1998).

[6] The caveat "other variables being equal" is significant. Homeowners may consume an appreciation-induced increase in real LTV through second mortgages, home equity lines, or other types of borrowings. Such a move would leave the individual's risk of insolvency unchanged in spite of the fact that LTV, based solely on the first mortgage, is higher.

[7] The two indexes shown in Figure 4 were chosen because they are among the longest time series of house prices available. A more appealing "repeat sales" index is published by the Office of Federal

relatively low rates in the 1970s and some rise in rates in the early 1980s. However, the relative stability of appreciation rates through most of the 1980s and 1990s is difficult to reconcile with the continued rising trend in foreclosure rates as well as with the plateau apparent in the mid-1990s.

In summary, several traditional determinants of mortgage default appear to explain some, but not all, of the long-term foreclosure rate trend. Rising LTVs associated with the transition to modern mortgage finance explain exceptionally low rates in the 1950s along with rising rates in the early 1960s. Increasing home appreciation explains falling rates in the late 1960s as well as modest rates throughout the 1970s. However, these variables stop short of explaining the secular rise during the 1980s and 1990s.

II. Trigger Events

Over the past several years it has become common to consider unexpected catastrophic events in an individual's life as "triggering" mortgage default. Elmer (1997) defines these "trigger events" as shocks that cause an "unanticipated shortfall in income such that income is no longer sufficient to meet periodic debt obligations."[8] Per this definition, a wide variety of income- or expense-related shocks, such as unemployment or divorce, may lead to insolvency and mortgage default. Is it possible that the incidence of trigger events could have increased sufficiently to explain the rising foreclosure rate trend?

Housing Enterprise Oversight (OFHEO), but it does not begin until 1980. As a check, we compared the OFHEO index to the two series in Figure 4 and found it had a comparable long-term trend. For example, the average OFHEO appreciation rate during the 1980–97 period was 4.26 percent, whereas the CPI rate was 4.68 percent and the NAR rate was 4.15 percent.

[8] This approach suggests that trigger events imply that solvency can be maintained only by an individual's borrowing against future income or wealth. Insolvency occurs if it is not possible to borrow sufficient funds to support current contractual debt obligations. Thus the incidence of trigger events relates to the accumulation of household debt, which is discussed in the next section.

Although Figure 2 eliminated unemployment rates as an explanation of the rising foreclosure rate trend, portions of the business sector have continued to experience problems even as unemployment rates have fallen. In this regard, Figure 5 points out that business failure rates rose dramatically in the early 1980s and have since remained at surprisingly high levels. Although the household effect of business failures should be reflected in unemployment rates, persistently high failure rates coincident with low unemployment add another dimension to the issue. As households increasingly rely on income from self-employment, they become more susceptible to the success or failure of these ventures. Since 1970 the number of workers classifying themselves as proprietors has more than doubled to over 25 million, and the proportion of the labor force composed of proprietors rose from 13.9 percent in 1975 to 16.4 percent in 1995. Since the bulk of business failures typically occur among small firms, the growth in the number of such firms in the 1980s helps explain the persistence of high business failure rates. More to the point, a rise in business failure rates coincident with an increase in household dependency on small business success suggests more than a casual linkage between business failures and residential mortgage foreclosure rates.

Divorce can motivate a variety of financial problems that last for many years, especially when alimony or child support payments are involved. Shelter, living, and other expenses typically increase dramatically without any increase in income. Ownership of the home may be contested or simply not resolved for years as the legal terms of the divorce are ironed out. Thus it is reasonable to expect a host of financial problems to develop from a rising trend in the divorce rate. As can be seen in Figure 6, divorce rates approximately doubled during the 1970s and have since remained high. This increase in rates almost certainly helped to ratchet foreclosure rates to higher levels in the 1980s. However, the gradual drop in divorce rates from the early 1980s onward makes it difficult to closely associate recent divorce rate trends with foreclosure rate trends.

A rarely cited source of problems is gambling, yet this activity, when practiced in excess, can easily lead to insolvency. Over the past twenty years facilities for casino gambling have come within driving distance of most major population centers. This has been the result of actions to legalize casino gambling on riverboats and Indian reservations as well as in specific geographic areas, such as Atlantic City. Thus it is not surprising that Figure 7 suggests a geometric growth rate for gambling as a percentage of consumption. Before 1975, casino gambling represented less than one-tenth of 1 percent of disposable income, yet by 1996 this percentage had increased by a factor of five to over 0.5 percent. Moreover, this increase does not include wagers placed in state lotteries or through illegal outlets. However, although gambling has increased sharply and appears to follow the general trend in foreclosures, it does not mirror periodic fluctuations in the foreclosure rate.

In fairness, although some trends appear to support the trigger event hypothesis, others seem to work against it. For example, death rates in the key earning ages 20–50 have declined steadily, and other developments have reduced the likelihood of unexpected births as well as the birthrate in general. Real disposable income has increased, so that at least a portion of the financial strains that plagued prior generations has been reduced. These factors suggest that one should at least consider additional perspectives before concluding the list of factors that might explain the foreclosure rate trend.

III. Household Risk Posture

A topic closely related to trigger events, but nevertheless distinct, is the financial risk posture of households. Individuals choose, of their own volition, their preferred levels of leverage, savings, insurance, and other variables that affect the extent to which they can absorb unexpected shocks. Of course, trigger events can be sufficiently severe so as to overwhelm even conservative individuals. However, the likelihood of a given event's causing problems increases as individuals increase leverage and/or reduce their insurance against catastrophe. The financial risk profile of a borrower also affects the way lenders react to delinquency. For example, traditionally lenders might forbear foreclosure if they believed a recently unemployed borrower would return to work. However, if borrowers have taken on too much debt or do not have readily available savings, lenders will be less likely to grant forbearance.

Savings represent a way for households to protect themselves against unforeseen financial shocks. Financial planners often counsel families to avoid high levels of debt and to "save for a rainy day," but Figure 8 shows that American families have not followed this advice. Consumer debt as a percentage of disposable income has reached historical highs and, on average, has been high since the early 1980s. Perhaps more pronounced is the drop in the personal savings rate. This rate fluctuated between a low of 6.6 percent and a high of 9.5 percent during the period 1950–81. However, it began a relatively steady secular decline in 1981 and had dropped to 3.8 percent by 1997.

Compounding the problem of lower savings rates is the fact that an increasing proportion of savings are being held in relatively illiquid forms, such as 401(k) and IRA types of retirement savings plans. Although one can make "hardship" withdrawals from a 401(k) plan to protect a home from foreclosure, the penalties are severe. The IRS requires the plan sponsor, or trustee, to withhold the estimated income tax on the withdrawn amount plus a penalty equal to 10 percent of the withdrawn amount. Thus, for example, a borrower who needs $1,000 to meet a mortgage obligation, and pays a 20 percent tax rate, would have to withdraw $1,428.57 to receive the amount needed. Hence, this type of tax-sheltered saving, while ideal for retirement, is not effective as a safety net for adverse shocks to income.

Rising household financial risk is also reflected in the debt-to-assets ratios found in Figure 9. These data show a secular increase in household leverage going back to the early 1950s, with interim fluctuations consistent with the foreclosure rate trend. Through 1966 the ratio rose from 7.3 percent to 12.2 percent, a high point coinciding with the peaking of the foreclosure rate in 1966. The ratio then remained relatively stable until 1972, whereas the foreclosure rate declined significantly. The remainder of the 1970s saw the beginning of a secular upward trend in both foreclosure rates and the leverage ratio. Only in the past several years, when the extraordinary rise in equity market prices led to large increases in household assets, did assets grow faster than debt, thus yielding a decline in the leverage ratio while the foreclosure rate rose.[9]

Not surprisingly, the vast majority (approximately 65 percent) of the increase in debt has been in the form of mortgage debt, which comports with the rising LTVs noted in Figure 3. Of course, the tax deductibility of mortgage interest stimulates individuals to rely on mortgage debt as a primary form of leverage. But how can tax incentives be motivating higher leverage if they have been in place for many years? Engen and Gale (1997) suggest a fresh perspective on this issue that provides an economic rationale for recent trends in increased mortgage borrowings. That is, their study finds that increased savings in 401(k) plans are associated with increased mortgage debt and a reduction in home equity. In essence, the financial advantages of 401(k) plans may be causing individuals to substitute savings in 401(k) plans for savings in home equity, thereby causing both mortgage leverage and the likelihood of default to increase.

In addition to savings, insurance provides individuals with a financial tool for guarding against the ill effects of unexpected problems. In this regard, Figure 10 emphasizes that a significant portion of the population is not covered by health insurance and that this percentage has increased by more than

[9] The ratio declined from 15.89 percent in 1994 to 14.87 percent in 1997. Between 1996 and 1997 household total assets grew by 11.48 percent while liabilities grew by 7.50 percent. Within the asset category, household holdings of corporate equities and mutual funds grew by 23.87 percent. See *Flow of Funds Accounts of the United States.*

one-third since the data were first reported for 1978. Moreover, this statistic understates the magnitude of the problem by including population segments that are covered by health insurance in their entirety, such as the military and senior citizens covered by Medicare. Thus, the increase in the portion of the population without health insurance constitutes a significant increase in the overall risk profile of households.

One can perform an intuitive test of the financial risk theme by comparing personal bankruptcy rates with foreclosure rates. Bankruptcy occurs when an individual's liabilities exceed his or her assets or when there is insufficient income to service debt obligations. Although there are many legal issues at the nexus between mortgage default and personal bankruptcy,[10] the two events nevertheless share a close association with financial distress. That is, both events can be motivated by shocks to income and/or by excessive leverage. Households faced with the burden of excessive debt or unanticipated financial hardship (illness, accident with no insurance, etc.) may try to resolve their problems by choosing personal bankruptcy and/or mortgage default.

If increasing household risk is causing an increase in the likelihood of financial distress, then personal bankruptcy rates should mimic increasing foreclosure rates. In fact, that is exactly what is observed. As Figure 11 shows, personal bankruptcy and mortgage foreclosure rates have tended upward for most of the past 25 years. With the exception of 1997, when personal bankruptcy rates spiked up, and the early 1980s when they trended downward, personal bankruptcy and mortgage foreclosure rates have moved in a comparable manner.

[10] Mortgages are treated differently from other types of debt in personal bankruptcy because the lender has a security interest in the real estate collateral. Moreover, most states have homestead exemptions that allow homeowners who declare bankruptcy to keep at least a portion of the equity in their principal residence subject to the first mortgage lien. In these instances, individuals experiencing financial hardship might find it advantageous to default on all obligations except their mortgage, and declare bankruptcy. Therefore, although mortgage foreclosure and personal bankruptcy are both distress-related events, they are not necessarily coterminous events.

The coincident rise in mortgage default and personal bankruptcy rates is also intriguing from the standpoint of society's attitudes toward leverage and financial risk. That is, the trends are consistent with the notion that households have increased their risk posture by opting for greater leverage and lower net savings. Of course, these trends also reflect the willingness of lenders to take on greater risk by increasing the availability of credit to highly leveraged households. Lenders and borrowers must both embrace these changing attitudes toward risk before an increase in risk can be contracted at market prices.

IV. Structural Change in Servicing Relationships

During the 1950s and 1960s most single-family mortgages were originated by "traditional" lenders, primarily savings and loan associations and mutual savings banks. In addition, mortgage bankers served as correspondents for insurance companies that invested in mortgages and for thrifts in capital-surplus areas, such as some cities in the Northeast. These "traditional" lenders performed all or most of the mortgage lending functions, including mortgage origination, servicing, portfolio management, and investment in the mortgages.[11] They were headquartered in the local markets, where they originated loans and typically had other business relationships with the mortgage borrowers.

The advent of mortgage securitization in the 1970s changed the borrower/lender relationship by breaking apart the various functions that had been performed by banks and thrifts. In particular, it became much less common for the same organization to both originate a mortgage and retain it as a portfolio investment. Lenders with traditional ties to the borrowers were replaced by national servicing

[11] Traditional banks and thrifts were the primary, but not the only, mortgage market participants before securitization. Mortgage bankers commonly originated FHA/VA products, and life insurance companies invested in whole loans. Figure 12 suggests that prior to the late 1970s these non-lender-serviced mortgages held a relatively stable 25 percent share of the mortgage market.

organizations with no tie to the borrower apart from the mortgage and with servicing policies based on national rather than local standards.

The "breakup" of the mortgage management function resulting from the shift toward mortgage securitization may have contributed to the rising trend in foreclosure rates by decreasing the likelihood that servicers would forbear foreclosing on delinquent borrowers. That is, the close relationship between borrower and lender found in the "traditional" local origination/servicing relationship may have been associated with a higher likelihood of forbearance (a lower likelihood of foreclosure) compared with modern relationships. Traditional lenders, with their greater knowledge of local economic conditions and better information about a borrower's financial problems, might have been more likely to forbear and/or restructure a mortgage.

At first impression, the servicing structure change hypothesis is easily supported by the well-known fact that securitization activity exploded during the past two decades and led to a significant change in mortgage management relationships. As shown in Figure 12, the portion of the mortgage market serviced by third parties rose dramatically during the 1980s and 1990s, a rise that corresponds to the most recent increase in mortgage foreclosure rates. The growth in third-party servicing is directly attributable to the growth in securitization, as the portion of the mortgage market funded through government-sponsored enterprises and federally sponsored pools rose from less than 2 percent in 1980 to about 50 percent in the mid-1990s.

The servicer structural change hypothesis is explored further in Figure 13, which compares the relationship between foreclosures and mortgages delinquent 90 or more days. If the hypothesis is valid, the rising trend in Figure 12 should be accompanied by an increased likelihood that delinquent loans are foreclosed on as soon as possible, and the ratio of foreclosures to delinquencies should rise. Unfortunately, the foreclosure/delinquency ratios shown in Figure 13 do not consistently support the hypothesis. For example, while the ratio for conventional loans jumped after 1988, it was relatively stable until the mid-1980s. Also, the trend in the conventional ratio does not comport with that of the FHA ratio despite the close relationship between FHA and conventional foreclosure rates presented in Figure 1. Indeed, the FHA foreclosure/delinquency ratio is highest in the early 1970s, a period of relatively low foreclosure rates. Therefore, only limited evidence supports the view that securitization-induced structural changes in mortgage servicing account for the rising long-term trend in foreclosure rates.

V. Empirical Results

The discussion to this point suggests that the mortgage foreclosure rate trend could be related to a number of factors. Although several traditional determinants of default, notably house appreciation and LTV, appear to explain portions of the long-term trend, they fall short of explaining the more recent, and unsettling, rising trend. Turning to other explanations, one sees that a noticeable increase has occurred in the incidence of several trigger events, such as gambling and the percentage of households without health insurance. Moreover, the risk posture of households appears to have increased along with their financial exposure to unexpected problems.

Consistent with the discussion found in sections I–III, we consider the effect of three sets of variables. First, traditional determinants of default, such as LTV, unemployment rate, and house appreciation, reflect the roles of variables that are widely known to affect default at the loan level. Second, variables associated with trigger events, such as business failure and divorce rates, capture the role of unexpected financial shocks. The third group of variables gauges consumers' risk posture, such as consumer debt burden, and the last measures structural changes in mortgage servicing policies. That is, the regressions take the following general form:

foreclosure rate = *f*(traditional determinants, trigger events, risk posture, servicing structural change).

This general specification can be used to test for the relative contribution of various economic forces on aggregate default patterns.[12]

The four economic themes can be examined with regression analysis that explains mortgage foreclosure rates (FOR) during the 1951–97 period. The first equation explains these rates with a traditional model containing four variables: unemployment (UN), current and lagged loan-to-value ratio (LTV and LTV1, respectively), and the personal savings rate (PSAV).[13]

$$\underset{(2.64)^{*}}{\text{FOR} = 0.05\ \text{UN}} + \underset{(3.04)^{*}}{0.30\ \text{LTV}} + \underset{(2.52)^{**}}{0.23\ \text{LTV1}} - \underset{(-2.15)^{**}}{0.04\ \text{PSAV}} \qquad (1)$$

Reg. $R^2 = 0.74$, Total $R^2 = 0.96$, D-W = 0.86 , df = 41

This model suppresses the intercept because the foreclosure rate approaches zero in the 1950s. Also, since autocorrelation is common in these types of time series, the regressions were estimated with Yule-Walker equations to correct for autoregressive characteristics.[14] Several other traditional variables were attempted, such as house appreciation and long-term interest rates, but none was consistently found significant.

Equation 1 suggests that traditional variables explain at least a portion of the foreclosure rate time series but fail to provide a robust explanation of the global trend. While all of the variables are

[12] For a full discussion of various empirical specifications and theoretical constructs, as well as a more detailed set of empirical results, see Elmer and Seelig (1998).

[13] A single asterisk ("*") signifies significance at the 1 percent level, whereas "**" signifies significance at the 5 percent level.

[14] *See* Judge et.al. (1985) for a discussion of this technique for dealing with autocorrelation.

significant and have their expected signs, several do not hold up during the past two decades. As shown in Figure 2, the unemployment rate has fallen dramatically during the past several years, yet the foreclosure rate has continued to rise. Similarly, LTVs rose modestly in the 1990s but remained at approximately the same level throughout most of the 1970s and 1980s. Therefore, although traditional variables can be shown to appear significant in regression-based tests, this finding does not necessarily imply that they adequately explain the long-term trend.

Adding the liabilities-to-assets ratio (LI/AS) to equation (1) enables us to test the marginal effect of a broader measure of household leverage while sensitizing the results from equation 1 for the inclusion of an additional variable.

$$\underset{}{FOR} = \underset{(1.25)}{0.02\ UN} - \underset{(-0.27)}{0.03\ LTV} - \underset{(-1.15)}{0.11\ LTV1} - \underset{(-2.35)^{**}}{0.03\ PSAV} + \underset{(4.54)^{*}}{6.23\ LI/AS} \qquad (2)$$

Reg. R^2 = .81, Total R^2 = .97, D-W = 1.24 , df = 40

In this case, the newly added liability variable is significant at the highest level, while the traditional unemployment and LTV variables become insignificant. Personal savings remains significant, thereby providing support to the household risk theme.

A third equation adds several trigger events, the business failure rate (BFAIL) and the divorce rate (DIV), to the liabilities-to-assets and personal savings variables found significant in equation 2.

$$FOR = \underset{(-3.18)^{*}}{-0.03\ PSAV} + \underset{(3.27)^{*}}{5.28\ LI/AS} + \underset{(3.92)^{*}}{0.01\ BFAIL} - \underset{(-1.13)}{0.01\ DIV} \qquad (3)$$

Reg. R^2 = .87, Total R^2 = .98, D-W = 1.48, df = 41

The results confirm the significance of the household risk variables from equation 2 and add at least one significant trigger event, the business failure rate. The divorce rate variable is not significant, although this result is not surprising in light of the 1970s run-up, and the subsequent slight downward trend, noted in Figure 6.

The inclusion of the share of mortgages serviced by someone other than the owner (SHSERV) to equation 3 allows us to test the hypothesis that a structural change in servicing relationships, caused by the growth in mortgage securitization, is responsible for the rising trend in foreclosure rates.

$$\underset{}{\text{FOR}} = \underset{(-2.75)^{*}}{-0.04\ \text{PSAV}} + \underset{(2.72)^{*}}{5.01\ \text{LI/AS}} + \underset{(2.62)^{**}}{0.003\ \text{BFAIL}} - \underset{(-1.49)}{0.01\ \text{DIV}} + \underset{(1.04)}{0.004\ \text{SHSERV}} \quad (4)$$

Reg. $R^2 = .90$, Total $R^2 = .98$, D-W. = 1.16, df = 39

The SHSERV variable was not statistically significant. This, therefore, further supports the view that one should reject the hypothesis that a structural change in servicing relationships explains the rising long-term trend in foreclosure rates.

As regards the long-term trend, the regression results are generally consistent with the notion that household risk is rising and that the rising risk is contributing to the rising long-term trend. Broader measures of household debt and savings tend to be more significant than narrower or traditional measures of risk, such as unemployment and LTV. Also, substituting the broader household risk variables for the more traditional variables tends to improve the explanatory power of the regressions. Some significance appears to accrue to trigger events, although the regression results offer only limited support in this area. Alternative specifications containing a broader range of variables are presented in Elmer and Seelig (1998).

Although the results in equation 3 are encouraging and support the notion that household risk may help to explain the foreclosure rate trend, they are nevertheless limited in several respects. Figures 1–13 clearly illustrate the fact that many of the long-term time series are severely autocorrelated.[15] Although the Yule-Walker equations are used to correct for this problem, it would be naïve to think that the problem has been entirely eliminated. A second problem is that a number of seemingly relevant variables discussed in previous sections, such as health insurance coverage and gambling, do not extend throughout the 1950–97 period. The tests are necessarily limited by their inability to include the full range of variables that might influence foreclosure rates. Finally, the availability of some variables is somewhat misleading because they do not accurately measure the intended effects. Most notably, although the shelter component of the CPI serves as an approximate index of house prices and extends back to the early 1950s, other house price indexes are generally preferred. Unfortunately, two preferred indexes, the NAR median sales price and OFHEO repeat sales indexes, extend back only to the late 1960s and early 1980s, respectively. Thus the value of a longer sample must be weighed against the cost of using less- appealing inputs.

VI. Conclusion

The advantage of examining economic trends over very long periods is that one can identify elements of trends that can be lost in shorter-term or cross-sectional analyses. Such is the case with the rising long-term trend in single-family mortgage foreclosures. This trend clearly suggests a secular rise in mortgage default risk that is not discussed in the myriad previous studies and bears almost no relation to very basic explanatory forces, such as the rate of interest. The consistency of the trend over the past two decades points to a need to examine its causes.

[15] While problems of nonstationarity in some of the data series make interpretation of the results

The rising long-term trend in foreclosure rates is at least partially explained by a variety of variables. Although several traditional determinants of default, notably house appreciation and LTV, explain some portion of the long-term trend, they appear to stop short of explaining the more recent, and unsettling, rising trend. In an effort to explain the remaining portion of the trend, we have explored the notion that the incidence of shocks to individual lifestyles or "trigger events," such as divorce, have increased. A related, but distinct, hypothesis is that the risk posture of individuals has increased, especially as individuals increasingly leverage their homes as part of a broader strategy of managing their overall wealth portfolio. Although evidence exists supporting both hypotheses, the risk posture hypothesis appears more consistent with a variety of disparate incentives and trends relating to household financial management.

Appendix

Extension of MBA FHA and Conventional Foreclosure Rates

The foreclosure rate series presented in Table A comes from several sources. Approximately half of the data are annualized rates of foreclosures started each quarter as published by Mortgage Bankers Association beginning in 1972 for loans insured by the FHA, loans insured by the VA, and conventional

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difficult, first difference estimates support the role of broader risk measures.

(non-FHA/VA) mortgages. The MBA data provide an excellent starting point for constructing a continuous time series because they constitute one of the longest time series of aggregate mortgage foreclosure rates.[16]

The post-1972 MBA data are extended to the earlier 1950–71 period with a two-step procedure. The first step involves extending MBA FHA foreclosure rates, found in column 1 of Table A, using aggregate FHA foreclosure rates published by the Department of Housing and Urban Development (HUD), found in column 2. The HUD FHA rates cannot be used directly before 1972, because they are reported on an "annual loans foreclosed" basis, which differs from the "foreclosures started" basis of MBA data. Since many more foreclosures are started than are consummated, the MBA FHA rates tend to be higher than the HUD FHA foreclosure rates, suggesting that the HUD rates must be adjusted upward to make them comparable to MBA rates. One makes this adjustment by finding the average MBA FHA foreclosure rate ratio during a period in which the two series overlapped. The period 1972–79 represents such a period, and the ratio during this period is 1.49. The MBA FHA data are thereby extended to 1950–71 as follows:

$$\text{1950–71 Extended MBA FHA} = 1.49 \text{ (1950–71 HUD FHA)}, \qquad \text{A-1}$$

with the entire series shown in column 3.

In the second step, post-1972 MBA conventional foreclosure rates, shown in column 4 of Table A, are extended to the 1950–71 period on the basis of the pre-1972 MBA FHA rates calculated in step 1.

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[16] The MBA series is calculated from a very large sample (currently over 20 million) of mortgages serviced by members of the MBA. A longer time series is available from the American Council of Life Insurance (ACLI). Although the ACLI series begins in 1965, in more recent years it is problematic because the underlying database of mortgages, from which the series is constructed, has dwindled as life insurance companies have moved out of single-family mortgages. For example, in 1970 these mortgages represented about one-third (about $75 billion) of ACLI sample respondent holdings, but in 1997 they had dropped to only 3 percent (about $4 billion). While the ACLI series exhibits the same long-term rising trend observed in the MBA data (see Figure 1), its declining sample reduces its reliability as an aggregate index.

This is accomplished with the assistance of conventional foreclosure rates published by the Federal Home Loan Bank Board (FHLBB) beginning in 1963 and shown in column 5. The FHLBB rates are convenient because they have often been reported with, and compared to, the HUD FHA rates in column 2.[17] The ratio of these two series thereby provides a basis for estimating pre-1972 conventional foreclosure rates. Specifically, one estimates 1963–71 MBA-consistent conventional foreclosure rates by multiplying pre-1972 extended MBA FHA foreclosure rates from column 3 by the ratio of the 1963–71 yearly FHLBB conventional and HUD FHA rates:

1963–71 Extended MBA Conventional = 1963–71 Extended MBA FHA (1963–71 FHLBB Conventional /HUD FHA). A-2

Before 1963, the pre-1972 MBA FHA series is multiplied by the average long-term ratio of MBA conventional and FHA foreclosure rates for the 1963–97 period, which equals 0.41:

1950–62 Extended MBA Conventional = 0.41 (1950–62 Extended MBA FHA). A-3

This approach ensures that conventional foreclosure rates lie below FHA rates while following the same aggregate trend. The final extended MBA conventional series is shown in column 6.

[17] For example, see 1964, 1966, and 1970 FHLBB *Annual Reports* for early data, and the *FHLBB Journal* throughout the 1970s for later data. The FHLBB data also have an intuitive appeal because their FHA and conventional rates follow the same general trends, but with the FHA rates considerably higher than the conventional rates in every period reported.

Table A

Extended MBA FHA and Conventional Foreclosure Rates: 1950-97

Year	MBA FHA Rate (1)	HUD FHA Rate (2)	Extended MBA FHA Rate (3)	MBA Convent. Rate (4)	FHLBB Convent. Rate (5)	Extended MBA Convent. Rate (6)
1950	N/A	0.20	0.00	N/A	N/A	0.00
1951	N/A	0.10	0.15	N/A	N/A	0.06
1952	N/A	0.09	0.13	N/A	N/A	0.05
1953	N/A	0.06	0.09	N/A	N/A	0.04
1954	N/A	0.18	0.26	N/A	N/A	0.11
1955	N/A	0.20	0.30	N/A	N/A	0.12
1956	N/A	0.25	0.37	N/A	N/A	0.15
1957	N/A	0.15	0.23	N/A	N/A	0.09
1958	N/A	0.13	0.20	N/A	N/A	0.08
1959	N/A	0.20	0.30	N/A	N/A	0.12
1960	N/A	0.33	0.49	N/A	N/A	0.20
1961	N/A	0.67	1.00	N/A	N/A	0.41
1962	N/A	0.97	1.44	N/A	N/A	0.59
1963	N/A	1.09	1.63	N/A	0.43	0.63
1964	N/A	1.18	1.76	N/A	0.46	0.69
1965	N/A	1.21	1.80	N/A	0.51	0.76
1966	N/A	1.20	1.79	N/A	0.52	0.78
1967	N/A	0.99	1.48	N/A	0.45	0.67
1968	N/A	0.76	1.13	N/A	0.29	0.43
1969	N/A	0.57	0.86	N/A	0.17	0.26
1970	N/A	0.60	0.90	N/A	0.14	0.21
1971	N/A	0.77	1.15	N/A	0.12	0.18
1972	1.29	0.95	1.29	0.16	0.10	0.16
1973	1.64	1.16	1.64	0.23	0.10	0.23
1974	1.50	1.15	1.50	0.31	0.11	0.31
1975	1.24	0.94	1.24	0.38	0.14	0.38
1976	0.89	0.64	0.89	0.32	0.14	0.32
1977	0.89	0.58	0.89	0.30	0.11	0.30
1978	0.86	0.52	0.86	0.25	0.09	0.25
1979	0.78	0.40	0.78	0.25	0.09	0.25
1980	0.73	N/A	0.73	0.31	0.12	0.31
1981	0.82	N/A	0.82	0.40	0.18	0.40
1982	1.06	N/A	1.06	0.52	0.33	0.52
1983	1.05	N/A	1.05	0.62	0.39	0.62
1984	1.03	N/A	1.03	0.62	N/A	0.62
1985	1.13	N/A	1.13	0.68	N/A	0.68

1986	1.26	N/A	1.26	0.75	N/A	0.75
1987	1.35	N/A	1.35	0.70	N/A	0.70
1988	1.47	N/A	1.47	0.69	N/A	0.69
1989	1.84	N/A	1.84	0.82	N/A	0.82
1990	1.73	N/A	1.73	0.83	N/A	0.83
1991	1.72	N/A	1.72	1.07	N/A	1.07
1992	1.79	N/A	1.79	1.03	N/A	1.03
1993	1.90	N/A	1.90	0.94	N/A	0.94
1994	2.22	N/A	2.22	0.90	N/A	0.90
1995	2.12	N/A	2.12	0.90	N/A	0.90
1996	2.31	N/A	2.31	0.99	N/A	0.99
1997	2.47	N/A	2.47	1.04	N/A	1.04

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Figure 1
Long-Term Trends for Conventional and FHA Foreclosure Rates Are Rising

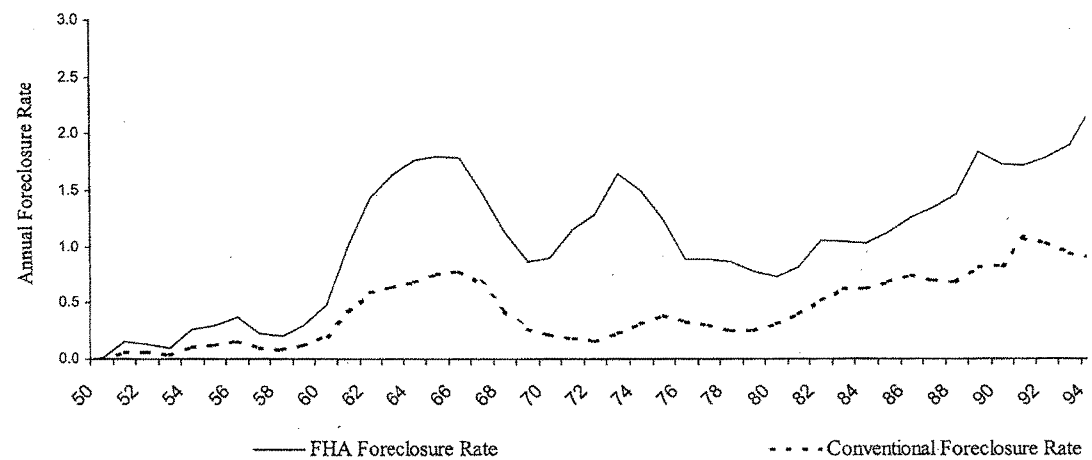
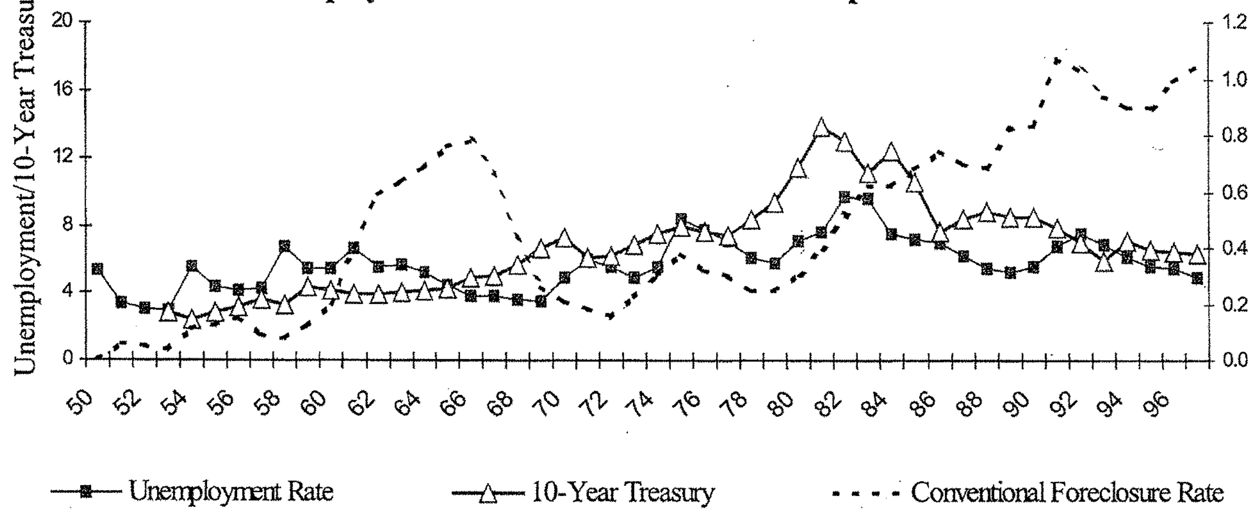
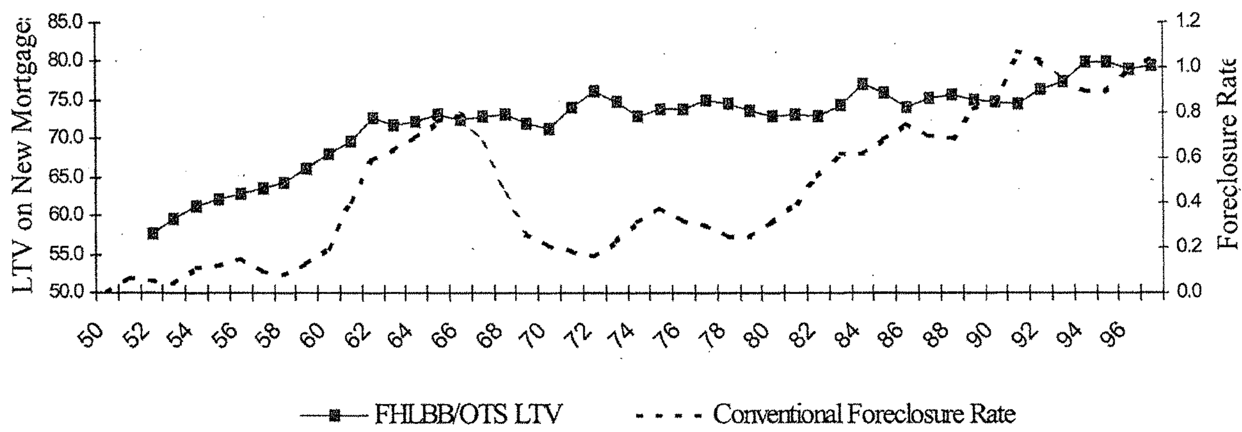


Figure 2
Unemployment and Interest Rates Fail to Explain the Trend



Source: MBA/FHLBB/HUD, Federal Reserve, Conference Board, NBER.

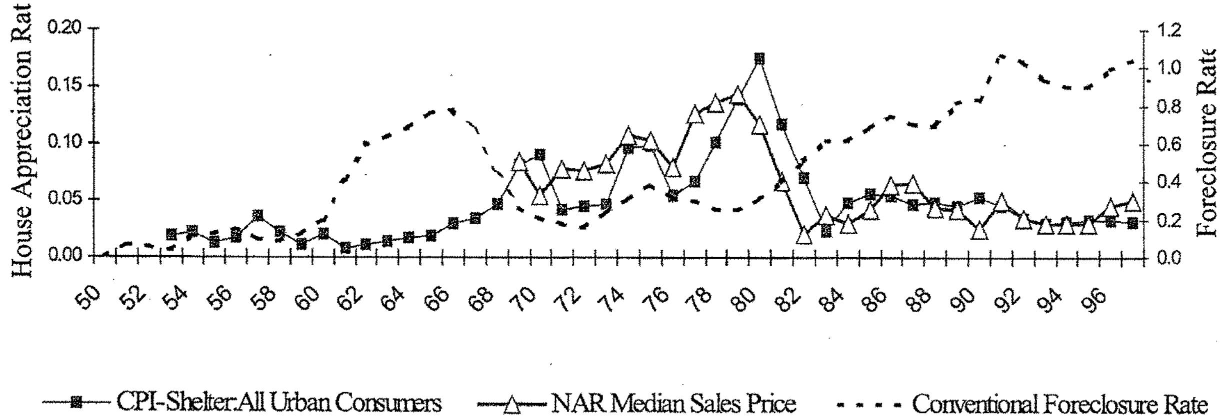
Figure 3
LTV Explains Some, But Not All, of the Trend



Source: MBA/FHLBB/HUD, FHLBB/Office of Thrift Supervision (OTS).

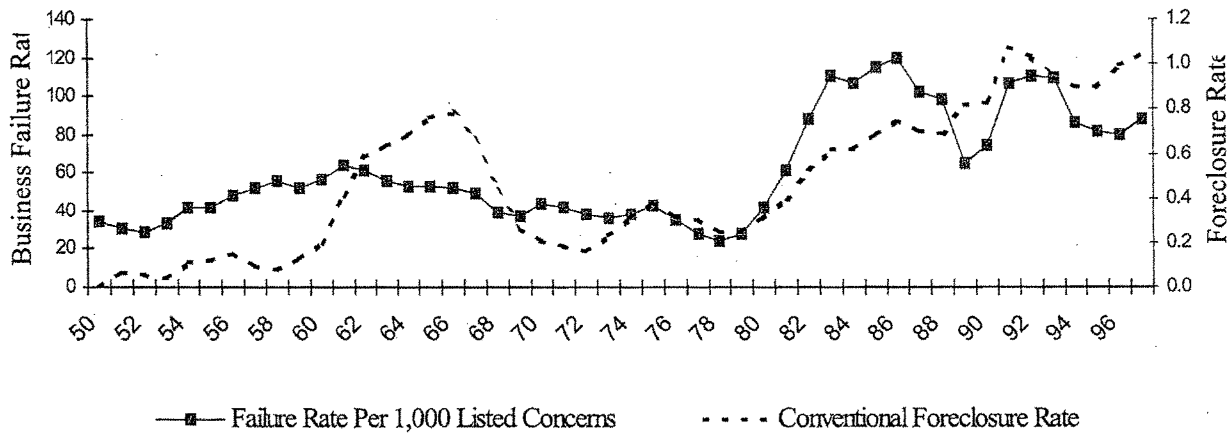
Figure 4

House Appreciation Rate Explains Some, But Not All, of the Trend



Source: MBA/FHLBB/HUD, BLS, National Association of Realtors (NAR).

Figure 5
Business Failure Rates Remain High Despite Good Economic Health



Source: MBA/FHLBB/HUD, Dunn and Bradstreet.

Figure 6
Divorce Rates Doubled in the 1970s and Have Remained High Since

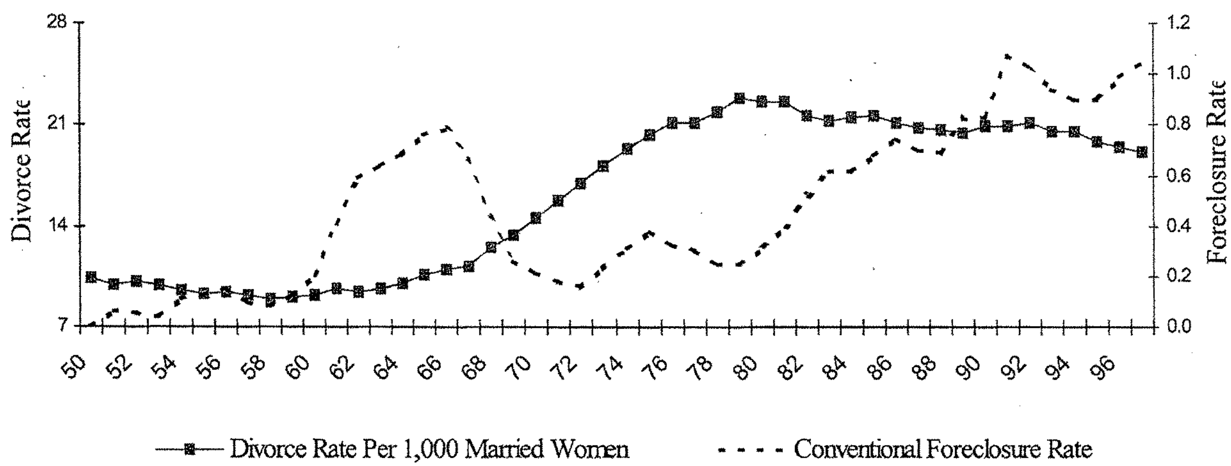
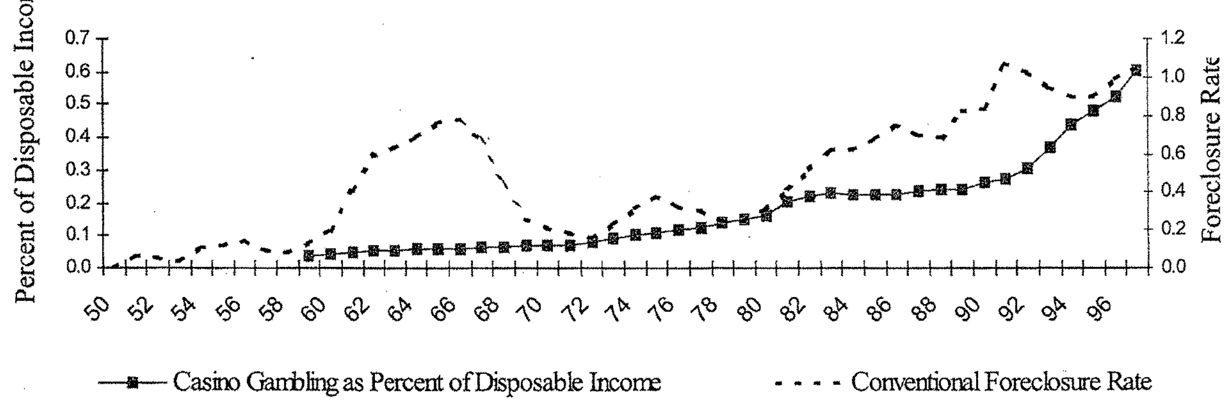


Figure 7
Gambling Is One of the Fastest-Growing Components of Consumption



Source: MBA/FHLBB/HUD, Bureau of Economic Analysis (BEA).

Figure 8
Consumer Debt Is at Historic Highs,
While Savings Rates Are at Historic Lows

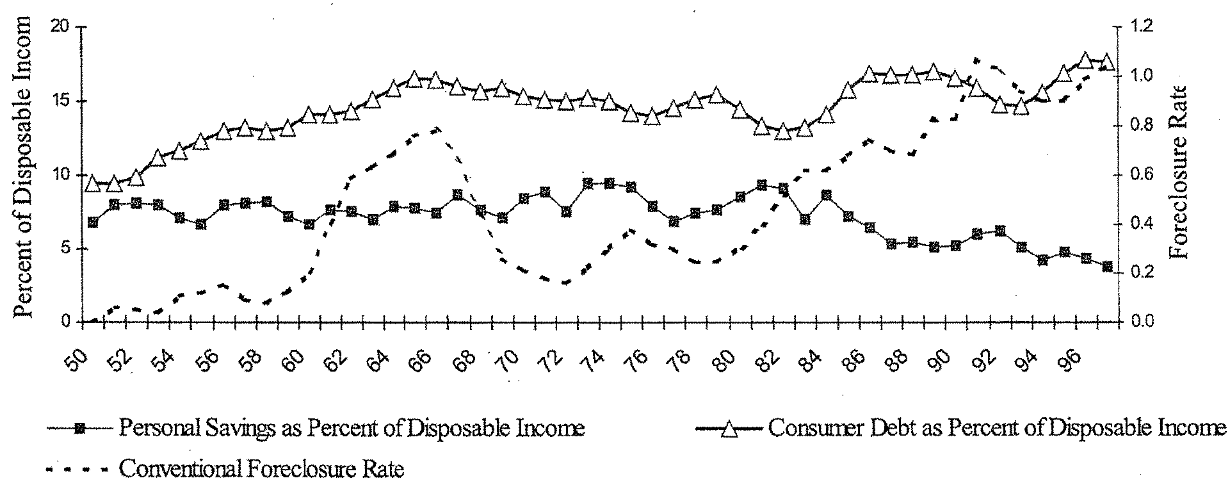


Figure 9
Total Personal Liabilities Steadily Increased Vis-a-Vis Total Assets

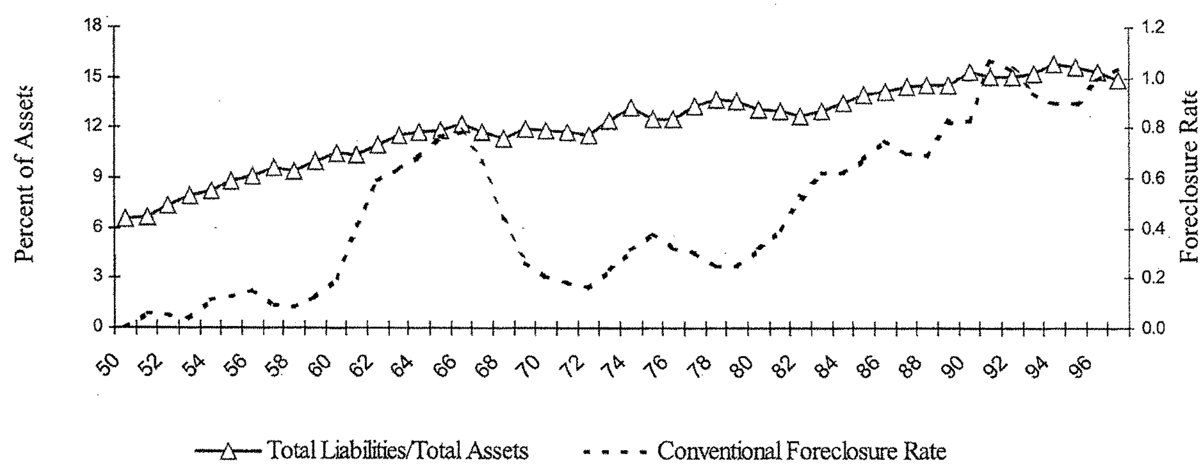


Figure 10
Percentage of Population Not Covered by Health Insurance Rose Througout the 1980s

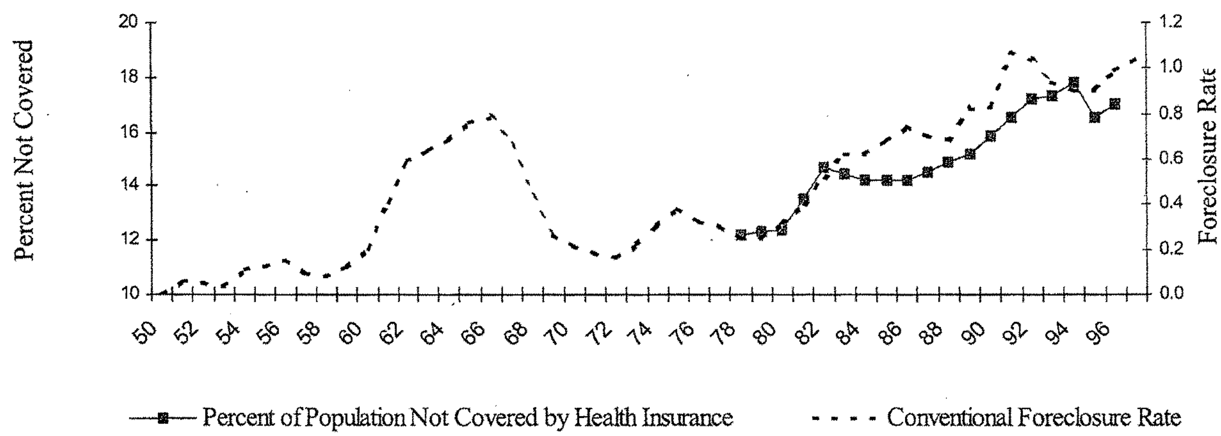


Figure 11
Personal Bankruptcy and Mortgage Foreclosure Rates Are Surprisingly Similar

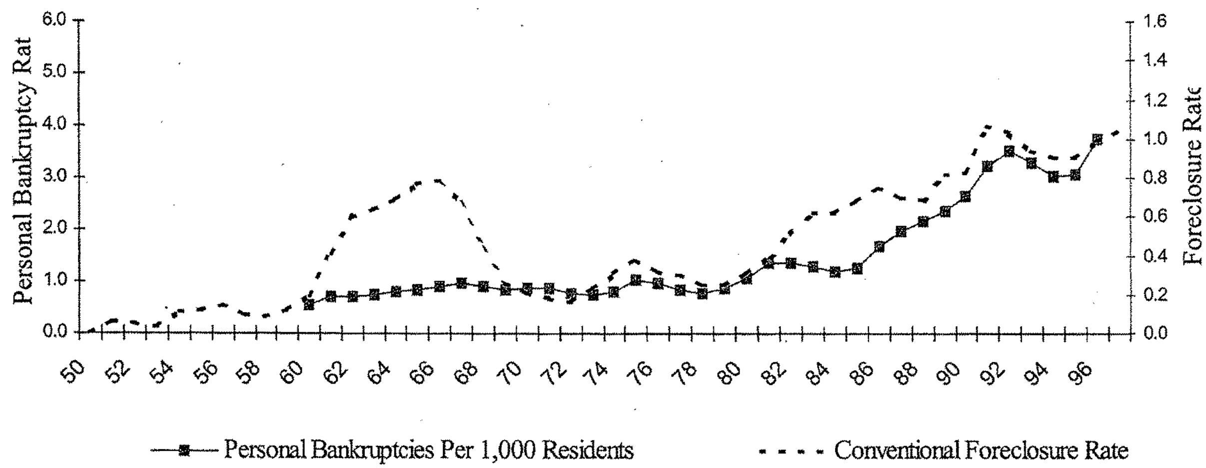
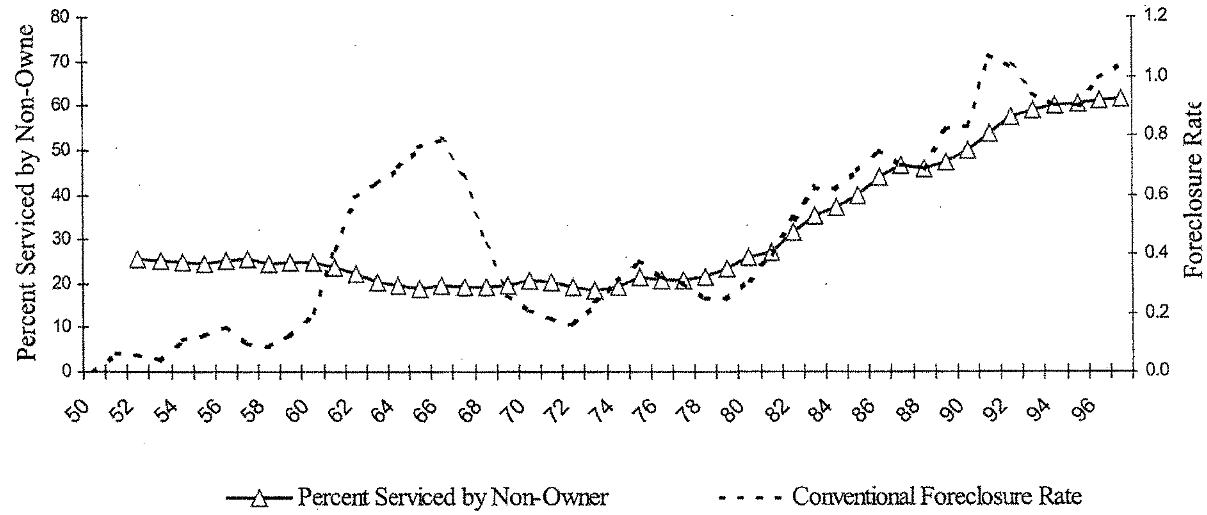
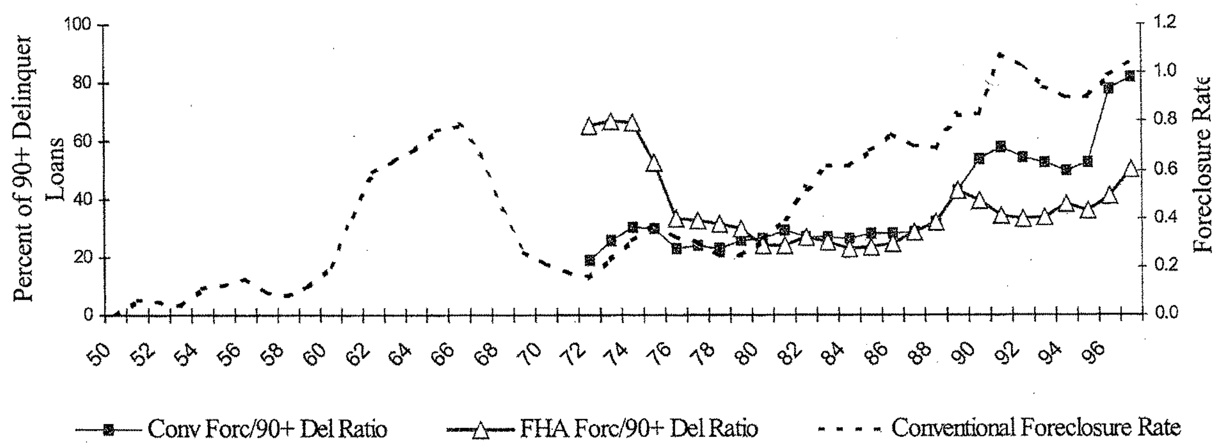


Figure 12
Share of Mortgages Not Serviced by Owner Rose Steadily After 1980



Source: MBA/FHLBB/HUD, FRB.

Figure 13
Inconsistent Behavior for Conventional and FHA Foreclosure Rates Relative to Delinquencies Over 90 Days in the 1980s



Source: MBA/FHLBB/HUD.

Attachment #2

The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values

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Abstract

To measure the impact of foreclosures on nearby property values, we use a database that combines data on 1997 and 1998 foreclosures with data on neighborhood characteristics and more than 9,600 single-family property transactions in Chicago in 1999. After controlling for some 40 characteristics of properties and their respective neighborhoods, we find that foreclosures of conventional single-family (one- to four-unit) loans have a significant impact on nearby property values. Our most conservative estimates indicate that each conventional foreclosure within an eighth of a mile of a single-family home results in a decline of 0.9 percent in value.

Cumulatively, this means that, for the entire city of Chicago, the 3,750 foreclosures that occurred in 1997 and 1998 are estimated to have reduced nearby property values by more than $598 million, for an average of $159,000 per foreclosure. This does not include effects on the value of condominiums, multifamily rental properties, and commercial buildings.

Keywords: Foreclosure; Homeownership; Mortgages

Introduction

Since at least the late 1960s, foreclosures of single-family homes (one- to four-unit) have been viewed as a serious threat to neighborhood stability and community well-being. Foreclosures, particularly in lower-income neighborhoods, can lead to vacant, boarded-up, or abandoned properties. These properties, in turn, contribute to physical disorder in a community, create a haven for criminal activity, discourage the formation of social capital, and lead to further disinvestment. If foreclosures lead to such negative effects, then we would expect them to also lead to lower property values in the immediate vicinity, especially for residential property.

In this article, we measure the impact of foreclosures on nearby property values by using a unique database that combines data on 1997 and 1998 foreclosures with data on neighborhood characteristics and more than 9,600 single-family property transactions in Chicago in 1999. Even after controlling for over 40 characteristics of properties and their respective neighborhoods, we find that foreclosures of conventional single-family loans have a significant impact on nearby property values. Our most conservative estimates indicate that each conventional foreclosure within an eighth of a mile of a single-family home results in a 0.9 percent decline in the value of that home. Cumulatively, this means that for the entire city of Chicago, the 3,750 foreclosures that occurred in 1997 and 1998 are estimated to have reduced nearby property values by more than $598 million, or an average of $159,000 per foreclosure. This does not include effects on the value of condominiums, larger multifamily rental properties, and commercial buildings.

Less conservative estimates suggest that each conventional foreclosure within an eighth of a mile of a property results in a 1.136 percent decline in that property's value and that each foreclosure between an eighth and a quarter of a mile away results in a 0.325 percent decline in value. This less conservative finding corresponds to a citywide loss in property values (again, not considering multifamily or commercial values) of just over $1.39 billion—or an average of more than $371,000 per foreclosure.

The private and social costs of foreclosures

Foreclosures can mean significant costs and hardships for those most directly affected in that they can involve not only the loss of accumulated home equity and the cost of acquiring the home, but also access to stable, decent housing. Moreover, foreclosures can damage credit ratings, hurting owners' prospects in credit, labor and insurance, and rental housing markets. There are potential psychological and emotional costs as well. For the holders of the loan, foreclosures are estimated to cost an average of $58,792 and take 18 months to resolve (Cutts and Green 2004).

But economic and social costs can have implications for surrounding neighborhoods and for larger communities as well as the parties directly involved. (For example, cities, counties, and school districts may lose tax revenue from abandoned homes.) The neighborhood and municipal costs of concentrated foreclosures are beginning to be recognized and quantified. These costs increase significantly for properties that are not quickly returned to the market via regular mechanisms.

In examining Federal Housing Administration (FHA) foreclosures, Moreno (1995) estimated average city costs of $27,000 and neighborhood costs of $10,000 for a foreclosure. Apgar and Duda (2005) found that the direct costs to Chicago city government involve more than a dozen agencies and two dozen specific municipal activities, generating government costs that exceed $30,000 per property in some cases.

One potential impact of increased foreclosures in a community is crime. Vacant and abandoned buildings are often considered a component of neighborhood physical disorder (as opposed to social disorder). Physical disorder involves "signs of negligence and unchecked decay" in a neighborhood (Skogan 1990, 4). Several observers and researchers have argued that physical and social disorder causes crime (Kelling and Coles 1996; Wilson and Kelling 1982) and that disorder undermines the ways in which communities maintain social control. Fewer residents are concerned about or take responsibility for disorder in public spaces outside their own households. Criminals flock to such communities because they do not fear being caught. Thus, social and physical disorder leads to more serious crime.

Skogan (1990) argues that abandoned buildings can harm a neighborhood in various ways. First, they can harbor decay. They may be havens for trash, rats, or other stray animals; squatters; or even criminals. Abandoned houses may also serve as places where drugs are sold and used or can be taken over by criminals who may attack neighborhood residents. Finally, abandoned or vacant homes may be targets for vandalism, the theft of wiring or other building components, or arson. Moreover, theft of property from such ostensibly unoccupied buildings may be less likely to be reported. Indirectly, the presence of boarded-up and abandoned buildings may lead neighborhood residents to exhibit a lack of collective concern over neighborhood crime.

In examining the relationship between neighborhood foreclosures and crime, Immergluck and Smith (2006) find that higher levels of foreclosures do contribute to higher levels of violent crime, although the results for property crime are not statistically significant. An increase of one standard deviation in the foreclosure rate (about 2.8 foreclosures for every 100 owner-occupied properties in one year) corresponds to an increase in neighborhood violent crime of approximately 6.7 percent.

Despite the persistence of the problem of concentrated foreclosures and their perceived ill effects, little systematic research has directly measured their impact on nearby property values. Some recent literature has addressed the impact of deteriorated or vacant residential buildings on property values or, conversely, the impact of rehabilitation on property values. Shlay and Whitman (2004) examined the impact of vacant housing units on nearby home values in

Philadelphia and found that properties located within 150 feet of an abandoned unit sold for over $7,000 less than other properties. Ding, Simons, and Baku (2000) found that housing rehabilitation and, especially, new construction have a positive effect on nearby property values and that this effect is larger in lower-income neighborhoods and in predominantly white neighborhoods.

In assessing the societal, as well as the individual, risks and costs of mortgage lending policies and programs, regulators and policy makers need to have better information on the spillover costs of foreclosures on neighborhoods and communities. A significant portion of the neighborhood costs of foreclosures should be capitalized into local property values. In this article, we seek to estimate such capitalized impacts.

Short- and long-term increases in foreclosures

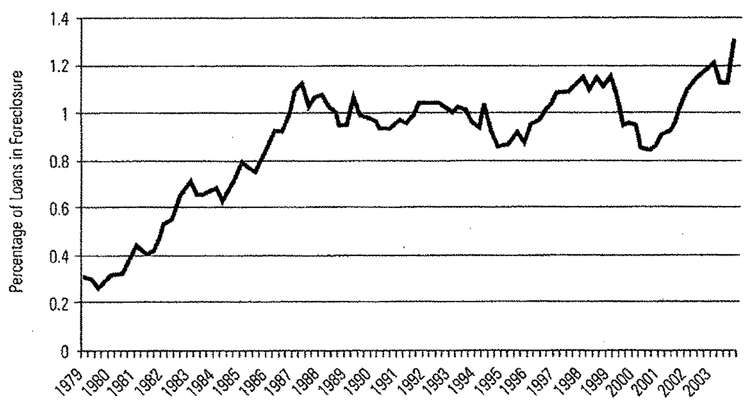
In the past decade, many cities have experienced substantial growth in foreclosures, with particularly large increases occurring during recent economic downturns. These increases have been particularly steep in low- and moderate-income and minority neighborhoods.

Nationally, foreclosure rates have ebbed and flowed, but over the long term, the trend has been decidedly upward. Figure 1 tracks foreclosure rates on all mortgage loans since 1979. In the early 1980s, foreclosure rates on conventional loans were on the order of 0.3 to 0.4 percent. They rose significantly over that decade to exceed 1 percent. Even as the economy grew in the late 1990s, foreclosure rates increased, exceeding 1.1 percent by late 1997. In the late 1990s and early 2000s, foreclosure levels reached historic highs (1.3 percent in late 2003) (Federal Deposit Insurance Corporation [FDIC] 2004).

At the state level, 23 states saw foreclosures increase more than 24 percent from the end of 2001 to the end of 2003, and 8 saw increases of more than 50 percent over the same period (FDIC 2004). States like Indiana, Ohio, Kentucky, South Carolina, Pennsylvania, and Mississippi all had foreclosure rates above 2 percent in late 2003. Increases have been particularly large in regions with weak economies. In Indiana, rates climbed steadily from less than 0.5 percent in 1995 to over 2 percent by 2003. In Pennsylvania, rates increased from less than 1 percent in 2000 to more than 1.5 percent by 2003 (National Association of Realtors, Research Division 2004).

However, economic conditions do not provide a sufficient explanation for why some regions and cities have experienced particularly severe increases. Using multiple regression to identify factors that explain state-level foreclosure rates for prime and subprime loans, Goldstein et al. (2005) found that income, average credit score, unemployment rate, owner-occupancy rate, and a number

Figure 1. Percentage of Outstanding Mortgages in Foreclosure at End of Quarter, 1979 to 2003

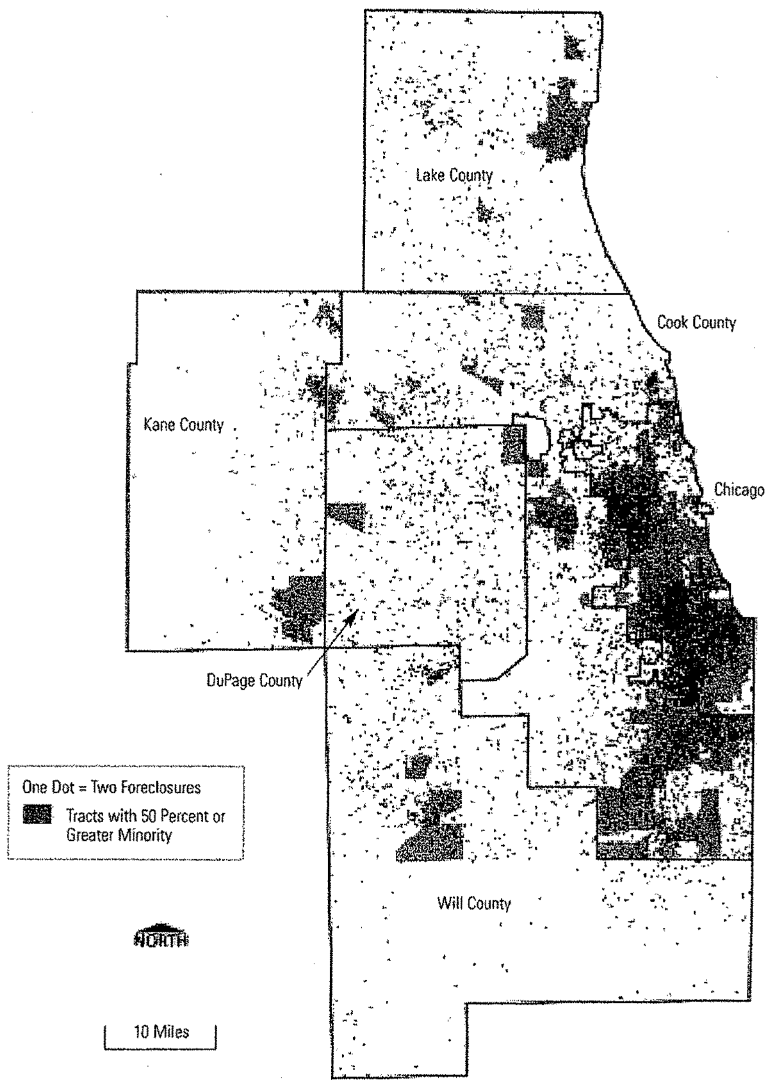


Source: National Association of Realtors, Research Division 2004.

of other demographic factors all have predictable impacts on the rate. But even after accounting for many independent variables, there was still substantial unexplained variance among state foreclosure rates, although the model explained a greater proportion of the variance among prime rates than among subprime rates (0.595 versus 0.453). States with large, positive standardized residuals (the standardized difference between the actual and predicted foreclosure rates) included Ohio, Indiana, Pennsylvania, Georgia, Maryland, South Dakota, and Missouri; there, the standardized residuals exceeded 1.0.

Cities, and especially lower-income and minority neighborhoods, have accounted for a disproportionate share of the increase in foreclosures. In the Chicago area, total foreclosures rose 238 percent from 1995 to 2002. In census tracts where less than 10 percent of the 2000 population consisted of minorities, there was an increase of 215 percent, while in tracts where 90 percent or more of the population consisted of minorities, there was an increase of 544 percent. Specifically, tracts with 90 percent or more minority residents in 2000 accounted for 40 percent of the 1995–2002 increase in conventional foreclosures. These same tracts represent only 9.2 percent of the owner-occupied housing units in the region. Tracts with minority populations of 50 percent or more accounted for over 61 percent of the increase in conventional foreclosures. Figure 2 illustrates the distribution of foreclosures in the Chicago metropolitan area in 2002.

Figure 2. Foreclosure Starts in the Chicago Area, 2002



Subprime lending and foreclosures

More than 30 years ago, when the FHA's loan programs began experiencing large increases in defaults, community activists recognized foreclosures as a threat to neighborhood and community stability. Despite some well-intentioned efforts to reverse the FHA redlining practices of previous decades, neglect and hostility toward the agency by various administrations and fundamental design flaws in its programs led to high levels of foreclosures in many older, working-class, and inner-city neighborhoods. FHA programs that worked fairly well when borrowers had options in the conventional lending market broke down in a system of "reverse redlining."

Unlike the FHA's earlier problems, today's foreclosures—and particularly the growth in foreclosures—are increasingly driven by conventional loans. In particular, high-risk subprime lending is resulting in substantially higher levels of foreclosures, with much of the increase concentrated in minority and lower-income communities. In the Chicago area, while foreclosures of government-guaranteed mortgages rose by 105 percent from 1995 to 2002, foreclosures of conventional mortgages increased 350 percent. As a result, while conventional loans accounted for only slightly more than half of foreclosures in 1995, they accounted for almost three out of four just seven years later.

Quercia, Stegman, and Davis (2005) found that 20.7 percent of all first-lien subprime refinancing loans originated in 1999 had entered foreclosure by December 2003 and that the rate at which subprime loans entered foreclosure in late 2003 was more than 10 times the rate for prime loans. In examining foreclosures in Philadelphia, Goldstein et al. (2005) estimated that some 40 percent of subprime loans made in 1998 or 1999 were in foreclosure between 2000 and 2003, compared with less than 3 percent of prime loans. In neighboring Montgomery County (PA), approximately 20 percent of subprime loans made in 1998 or 1999 were in foreclosure during the same period, compared with less than 0.4 percent of prime loans.

In the case of refinance lending, for example, Immergluck and Smith (2005) found that, other things being equal, 100 more subprime loans in a census tract over a five-year period led to almost eight foreclosures in a single year following this period. They also found that the effect of subprime lending on foreclosures is generally on the order of 20 to 30 times the effect of prime lending.

While the specific magnitude of foreclosure rates varies by the type of data, the way they are measured, and the timeframes and geographies involved, it is clear that in recent years, subprime loans had a propensity for foreclosure 10 to 40 times higher than prime loans did, with the lower differential frequently occurring in areas where prime foreclosure rates were already quite high.

Measuring the effect of foreclosures on nearby property values

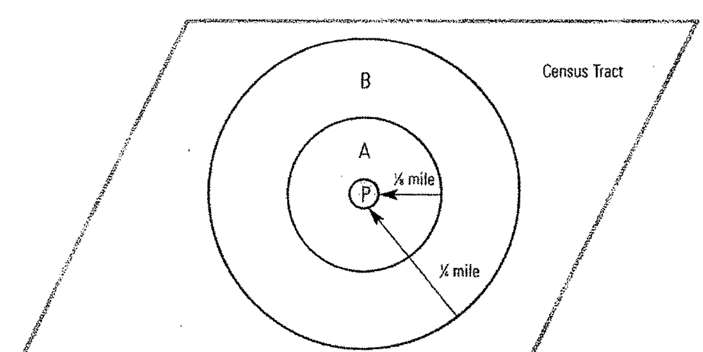
We use a hedonic regression model to estimate the impact of foreclosures on the value of nearby single-family properties and to discern the independent effect (that is, controlling for other explanatory variables) of a change in an attribute or location of a property on its price. Figure 3 provides a schematic representation of our hedonic model of housing values and nearby foreclosures. In this model, each property sale, p, is situated in 1 of the more than 800 census tracts in Chicago. Around each property, we draw two buffer areas, one with a radius of an eighth of a mile and one with a radius of a quarter of a mile. From the literature on the effects of proximate phenomena on property values, we assume that significant impacts of foreclosures on property values will occur within a quarter of a mile or less. We then measure the number of foreclosures within a buffer distance of an eighth of a mile (area A) and the number of foreclosures between a radius of an eighth of a mile and a quarter of a mile (area B).

To estimate the value of a property, p, we develop a pricing model as follows:

$$\begin{aligned}\mathrm{Ln}(p_i) = \alpha + \beta_1 X_i + \beta_2 Z_i + \beta_3 AC_i + \beta_4 BC_i + \beta_5 AG_i + \beta_6 BG_i \\ + \beta_7 AO_i + \beta_8 BO_i + \varepsilon_i \end{aligned} \qquad (1)$$

where $\mathrm{Ln}(p)$ is the natural log of the price of the property, X is a vector of property characteristics (e.g., square footage, garage, construction, etc.), and Z is a vector of neighborhood characteristics (population density, income, race, etc.,

Figure 3. Modeling the Impact of Forecosures on Property Values



as well as locational measures such as longitude and latitude), as measured by 2000 census tract data. The remaining variables measure the phenomena of interest—foreclosures. Specifically we disaggregate the following types:

1. AC is the number of foreclosures of conventional single-family loans within an eighth of a mile from the property.
2. BC is the number of foreclosures of conventional single family loans between an eighth and a quarter of a mile from the property.
3. AG is the number of foreclosures of government-insured single-family loans within an eighth of a mile from the property.
4. BG is the number of foreclosures of government-insured single-family loans between an eighth and a quarter of a mile from the property.
5. AO is the number of other foreclosures (multifamily and commercial property) within an eighth of a mile from the property.
6. BO is the number of other foreclosures (multifamily and commercial property) between an eighth and a quarter of a mile from the property.

To estimate equation (1), we were able to obtain property characteristics and sales prices for over 9,600 detached, single-family properties that were sold in Chicago in 1999. These data do not include all single-family transactions in the city. The data were originally assembled by the Illinois Department of Revenue, which obtains them from state real estate transfer tax records. The department cleaned the data, eliminated transactions that have extreme ratios of sales price to assessed value, and then provided a 50 percent random sample of the remaining residential property sales.

Data on property characteristics are from the Cook County Assessor's office and are for the 1999 assessment year. Because we expect a lag between foreclosures and their effect on property values, we gathered data on foreclosures in the city in 1997 and 1998.

Before we estimate equation (1), it is helpful to examine the average values of the independent variables of interest for different types of neighborhoods. Table 1 breaks these variables out by the income level of the census tract. It shows that the average number of foreclosures surrounding a property within a radius of an eighth of a mile drops from 2.07 conventional and 1.08 government foreclosures in low-income tracts to 0.38 conventional foreclosures and 0.09 government foreclosures surrounding properties in upper-income tracts. Between an eighth and a quarter of a mile, the average number of conventional foreclosures drops from 5.49 for low-income tracts to 1.03 for upper-income tracts, and the average number of government-guaranteed foreclosures drops

Table 1. Average Number of Nearby Foreclosures (1997 and 1998) by Neighborhood Income, Chicago

Number of Foreclosures by Type and Radius	Income of the Census Tract, 1999 Low	Moderate	Middle	Upper
Conventional, within 1/8 mile	2.07	1.74	0.78	0.38
Government, within 1/8 mile	1.08	0.99	0.37	0.09
Conventional, 1/8 to 1/4 mile	5.49	4.50	2.23	1.03
Government, 1/8 to 1/4 mile	2.79	2.69	1.04	0.23
Other, within 1/8 mile	0.13	0.14	0.06	0.03
Other, 1/8 to 1/4 mile	0.60	0.46	0.18	0.15
Average sales price	$99,117	$113,286	$147,987	$294,408

Note: Low-income tracts are those where median family income is below 50 percent of the metropolitan median income. Moderate-income tracts are those where median family income is between 50 and 79 percent of the metropolitan median. Middle-income tracts are those where median family income is between 80 and 119 percent of the metropolitan median. Upper-income tracts are those where median family income is 120 percent or more of the metropolitan median.

from 2.79 to 0.23, respectively. Multifamily and commercial foreclosures (grouped here as "other") exhibit similar patterns.

On average, the number of conventional foreclosures within a block (an eighth of a mile) of properties in low-income tracts is more than five times the number of conventional foreclosures within a block of properties in upper-income tracts. In the case of government-guaranteed loans, the difference is more than 11-fold. Similar differences occur when foreclosures between one and two blocks away are considered.

Results of the multivariate analysis

The estimation of equation (1) is presented in table 2. Results are given for two versions of the equation. The first model includes all available property characteristics, neighborhood characteristics expected to influence property values, and the foreclosure variables. The second includes an additional independent variable: the median home value for the census tract in which the property is located. This variable, which is added to control for the possible effect of nearby property values on the central property value, p, also reduces the vulnerability of the results to concerns that there may be important variables that change across neighborhood space, that these are unmeasured or unobserved, and that they influence p.

The first model (without tract median property value) gives results for most property and neighborhood characteristics that are generally consistent with previous research on property values, as well as with theory. Most, but

Table 2. Regression Results for Estimation of Single-Family Property Values

	Without Tract Median Property Value		With Tract Median Property Value	
	Coefficient	Standard Error	Coefficient	Standard Error
(Constant)	8.20622	0.12882***	7.20178	0.12346***
LN(LAND AREA)	0.17683	0.01157***	0.21856	0.01088***
LN(BLDNG AREA)	0.46189	0.01668***	0.41050	0.01566***
AGE	−0.00205	0.00017***	−0.00210	0.00016***
# of BEDROOMS	0.00711	0.00562	0.01609	0.00526***
TWO STORY+ ?	−0.03792	0.00879***	−0.04633	0.00822***
MASONRY?	−0.01300	0.00863	0.00445	0.00808
FRAME/MASONRY?	−0.01795	0.01285	−0.00589	0.01202
SLAB?	0.02307	0.01017**	0.01771	0.00951*
BASMNT FINSHED?	0.01476	0.00809*	0.01199	0.00756
FULLATTIC?	−0.00301	0.00908	−0.00826	0.00849
PARTIAL ATTIC?	0.02498	0.01041**	0.00939	0.00974
ATTICFINISHED?	0.01077	0.01090	0.00385	0.01020
CENTRAL AIR?	0.02882	0.00897***	0.01686	0.00839**
1-CAR GARAGE?	0.03690	0.00859***	0.02222	0.00804***
2-CAR GARAGE?	0.07122	0.00843***	0.05355	0.00789***
FIREPLACE?	0.12510	0.01184***	0.08725	0.01112***
RAIL W/IN 1/8 ML?	−0.01845	0.00785***	−0.02662	0.00735***
MILES TO EL TRAIN	−0.04954	0.00567***	−0.04948	0.00530***
MILES TO HIWAY	0.00621	0.00367*	0.01130	0.00344***
APRL_JUN?	0.04891	0.00927***	0.04941	0.00867***
JULY_SEP?	0.07850	0.00921***	0.07393	0.00861***
OCT_DEC?	0.07465	0.01019***	0.07359	0.00953***
LATITUDE	2.22553	0.15494***	1.47511	0.14629***
LONGITUDE	−2.59858	0.23966***	−2.02806	0.22463***
LAT*LAT	−3.31249	0.77186***	0.88124	0.73055
LONG*LONG	5.52803	1.47679***	9.88299	1.38592***
LAT*LONG	−13.08793	1.43754***	−11.86481	1.34465***
POPDENSITY	3.649E-06	6.288E-07***	3.633E-06	5.880E-07***
LOWINCOME	−0.53197	0.02574***	−0.26993	0.02509***
MODINCONE	−0.37888	0.01624***	−0.13476	0.01654***
MIDDLEINCOME	−0.20987	0.01065***	−0.03843	0.01097***
PPUBASSISTNCE	−1.42312	0.13112***	−1.01365	0.12310***
PPOWNOCC	−0.34445	0.03045***	−0.21342	0.02869***
VCRIME/CAPITA	−3.71817	0.66097***	−3.15170	0.61826***
PPBLACK	−0.41891	0.02535***	−0.25280	0.02412***
PPHISPANIC	−0.43438	0.02405***	−0.21386	0.02326***
CNVL_1/8	−0.01136	0.00291***	−0.00907	0.00272***
CNVL_1/8-1/4	−0.00325	0.00158**	−0.00189	0.00148

Table 2. Regression Results for Estimation of Single-Family Property Values *Continued*

	Without Tract Median Property Value		With Tract Median Property Value	
	Coefficient	Standard Error	Coefficient	Standard Error
GOV_1/8	−0.00299	0.00422	−0.00331	0.00394
GOV_1/8-1/4	0.00063	0.00233	−0.00131	0.00217
OTHER_1/8	−0.05745	0.01042***	−0.04672	0.00975***
OTHER_1/8-1/4	−0.01618	0.00592***	−0.01015	0.00554*
Median home value			2.963E-06	7.977E-08***
R^2	0.727		0.761	
N = 9,642				

Note: The dependent variable is the natural log of the sales price of a single-family property.
$^*p < 0.10$. $^{**}p < 0.05$. $^{***}p < 0.01$.

not all, property characteristics are measured by dummy variables, with a 1 indicating the presence of the feature (e.g., masonry construction) and a zero indicating its absence. (Dummy variables are followed by a question mark.) An increase in the square footage of the home itself, or the land, results in increased value. Other things being equal, single-story buildings are more valuable than multistory ones. Amenities such as a finished basement, central air conditioning, a fireplace, and a one- or two-car garage add value. On the one hand, being located within a block or so of a railroad track reduces property values, while on the other, value declines as the distance from an elevated train or subway stop increases. The regression also controls for seasonality effects on prices, which prove to be significant.

Neighborhood characteristics prove to be quite significant predictors of property values. Lower incomes among residents, higher percentages of residents on public assistance, and higher levels of violent crime are among the variables that have negative effects on property values.

Four variables are included to control for the possibility that the impacts of the neighborhood and property characteristics on value vary across space. It may be that the attributes of a property contribute differently to value in some parts of the city as opposed to others. This phenomenon, sometimes called spatial submarket segmentation, can be accounted for by an econometric technique that controls for spatial location throughout the city.[1]

[1] This technique is referred to as spatial contextual expansion with quadratic trend. See Galster et al. (2004).

This method entails including the latitude, the longitude, the latitude squared, the longitude squared, and the product of the latitude and longitude as independent variables. They are generally highly significant, indicating the presence of spatial submarkets within the city.

The variables that indicate the effect of foreclosures on property values are the last six in the first regression (CNVL_1/8 through OTHER_1/8-1/4). The results of the first model indicate that nearby foreclosures generally have significant, negative effects on property values. However, the results for foreclosures of government-guaranteed loans are not significant, and the sign is somewhat ambiguous. Moreover, while the magnitude of the coefficients for the multifamily and commercial foreclosures combined is somewhat larger than for single-family foreclosures, table 1 shows that the incidence of such foreclosures is much lower, so that as a group, they are less important than single-family foreclosures.

When other things are held constant, for each additional conventional foreclosure within an eighth of a mile of a house, property value is expected to decrease by 1.136 percent. Given an average sales price of $164,599 for homes in the city, this amounts to a decrease in value of approximately $1,870 per property because of a single foreclosure within an eighth of a mile. For foreclosures in the band from an eighth to a quarter of a mile from a property, the effect is 0.325 percent per foreclosure. The marginal effect of a multifamily or commercial foreclosure is somewhat larger than the effect of a conventional single-family foreclosure simply because these buildings tend to be much larger and therefore have significantly more capacity for physical disorder.

In the second, expanded regression, most variables that were significant in the first regression remain so and tend to carry the same sign. In this more conservative estimate, the coefficient on conventional foreclosures within an eighth of a mile is somewhat smaller, but the impact of an additional foreclosure on property value remains close to a 1 percent reduction (0.9 percent). In this specification, the effect of foreclosures in the second band (an eighth to a quarter of a mile) remains negative, but becomes statistically insignificant. Government foreclosures are still statistically insignificant.

It is important to point out that the methods used in this analysis have certain limitations. First, while we have included a wide variety of structural and neighborhood characteristics, especially those that are found to be important in the literature on property values, the data on structural characteristics are limited by what the county assessor collects and reports. Second, while we did run a model using a regular, nonlogged version of sales prices and found similar results, there are other possible sensitivities to functional form that might be worth additional exploration. In particular, problems of multicollinearity prohibited us from testing for interactions between neighborhood attributes such as race and income. A larger, broader data set might reduce such problems.

Finally, there remains a possibility that the negative relationship between foreclosures and property values is as much the effect of property values on foreclosures as the other way around. If the lower value of the observed property (the centroid in figure 3) is highly correlated with those of nearby properties, then we may be measuring the impact of lower value on the likelihood of foreclosure. Other things being equal, a lower property value and, more important, lower owner equity are likely to positively affect the probability of foreclosure because the owner has less equity at risk.

We attempt to minimize the problem of reverse causation in two ways. First, the spatial structure of our model, as illustrated by figure 3, measures the effects of surrounding foreclosures on the value of a single property at the central focus of the foreclosures. Second—and related to the first point—is the addition of neighborhood median property value as an additional independent variable. Because nearby property values may affect foreclosures in areas A and B in figure 3, we control for such values, although perhaps imperfectly, via the median tract value.

The use of the median home value for the tract is by no means a perfect method for dealing with the potential endogeneity of the nearby foreclosures. Our data on nearby property values are measured at the census-tract level, which is larger than the eighth of a mile radius around each property. However, it was the best method available. We could not identify any appropriate instruments with which to address endogeneity via an instrumental variables approach. In addition, change-over-time analysis was precluded by the limited sales and property data available. Future research should aim to address these limitations.

Effects of foreclosures on property values in low- and moderate-income tracts

Given that low- and moderate-income neighborhoods experience a substantially higher level of foreclosures and given that such foreclosures may be more likely in vacant, abandoned, or blighted property than in property in more affluent areas, it is useful to determine whether the effects of foreclosures in such neighborhoods differ from the effects for all transactions. To do this, we estimate equation (1), both the basic and expanded versions, for only the 2,265 property transactions in low- and moderate-income tracts in the city.

As seen in table 3, the results of the regression without median home value indicate that for each additional foreclosure within an eighth of a mile of a

Table 3. Regression Results for Estimation of Single-Family Property Values: Low and Moderate-Income Tracts Only

	Without Tract Median Property Value		With Tract Median Property Value	
	Coefficient	Standard Error	Coefficient	Standard Error
(Constant)	7.37096	0.34354***	6.99667	0.32539***
LN(LAND AREA)	0.30429	0.03274***	0.31818	0.03095***
LN(BLDNG AREA)	0.38210	0.04555***	0.26966	0.04358***
AGE	−0.00259	0.00042***	−0.00249	0.00040***
# of BEDROOMS	0.00451	0.01480	0.01623	0.01400
TWO STORY+ ?	−0.02011	0.02771	−0.02561	0.02619
MASONRY?	0.05343	0.02370**	0.05471	0.02239**
FRAME/MASONRY?	0.06078	0.03804	0.05468	0.03594
SLAB?	0.06074	0.02743**	0.04441	0.02594*
BASMNT FINSHED?	0.00628	0.02452	0.00517	0.02317
FULLATTIC?	−0.01264	0.02568	−0.02741	0.02428
PARTIAL ATTIC?	0.07808	0.03145**	0.03821	0.02982
ATTICFINISHED?	0.03305	0.03073	0.01771	0.02905
CENTRAL AIR?	0.05745	0.03678	0.05179	0.03475
1-CAR GARAGE?	0.04872	0.02279***	0.03378	0.02155
2-CAR GARAGE?	0.05765	0.02303***	0.04827	0.02177**
FIREPLACE?	0.20408	0.04046***	0.14086	0.03843***
RAIL W/IN 1/8 ML?	−0.07384	0.02051***	−0.05962	0.01939***
MILES TO EL TRAIN	−0.04295	0.01880**	−0.04099	0.01776**
MILES TO HIWAY	−0.03628	0.01670**	0.01183	0.01605
APRL_JUN?	0.06782	0.02605***	0.05872	0.02462**
JULY_SEP?	0.09813	0.02599***	0.08662	0.02456***
OCT_DEC?	0.08820	0.02754***	0.07850	0.02603***
LATITUDE	2.63795	0.58542***	1.96816	0.55464***
LONGITUDE	−0.22046	0.89249	−1.06925	0.84485
LAT*LAT	4.17514	2.53047*	6.58625	2.39543***
LONG*LONG	−2.65742	6.13045	7.36781	5.82458
LAT*LONG	−4.68975	7.56949	−10.11835	7.15967
POPDENSITY	−5.522E-07	1.310E-06	8.400E-07	1.241E-06
LOWINCOME	−0.06440	0.03031**	−0.08024	0.02866***
PPUBASSISTNCE	−0.35926	0.24600	0.19156	0.23485
PPOWNOCC	−0.07457	0.09109	0.03952	0.08634
VCRIME/CAPITA	−4.92566	1.24905***	−3.72182	1.18244***
PPBLACK	−0.77435	0.08212***	−0.49459	0.07945***
PPHISPANIC	−0.66048	0.08150***	−0.36556	0.07908***
CNVL_1/8	−0.01792	0.00594***	−0.01442	0.00561***
CNVL_1/8-1/4	−0.00033	0.00321	0.00045	0.00304
GOV_1/8	0.00709	0.00810	0.00446	0.00766

Table 3. Regression Results for Estimation of Single-Family Property Values: Low and Moderate-Income Tracts Only *Continued*

	Without Tract Median Property Value		With Tract Median Property Value	
	Coefficient	Standard Error	Coefficient	Standard Error
GOV_1/8-1/4	0.00500	0.00466	0.00175	0.00440
OTHER_1/8	−0.03761	0.02242*	−0.02923	0.02119
OTHER_1/8-1/4	−0.01350	0.01213	−0.00981	0.01146
Median home value			4.098E-06	2.502E-07***
R^2	0.538		0.588	
N = 2,265				

Note: The dependent variable is the natural log of the sales price of a single-family property.
$^{*}p < 0.10$. $^{**}p < 0.05$. $^{***}p < 0.01$.

house, property value drops by almost 1.8 percent. The average selling price in low- and moderate-income tracts is $111,002, so this effect amounts to approximately $1,989 for such a property. The more conservative estimate of the effect of close-in foreclosures, obtained in the expanded regression with median tract value included, is 1.44 percent or about $1,600 for the average property.

Summing up the effects of foreclosures and property values

The marginal impact on property values from one additional foreclosure on one nearby property can be used to estimate the cumulative effects of increased foreclosures on single-family property values throughout the city. We begin by estimating the impact of foreclosures at the tract level. For each tract, the impact of conventional single-family (one- to four-unit) foreclosures on the value of single-family (one- to four-unit) buildings is calculated. (These estimates do not include any effects on the value of condominiums, multifamily rental properties, or commercial properties.) We use the marginal effects (coefficient values) from table 2. For each tract, the cumulative effect of 1997 and 1998 foreclosures on property values within a quarter of a mile is then estimated as follows:

> Cumulative tract-level decline in the values of single-family properties = [Number of foreclosures in the tract]*[median home value in the tract]*[(average number of single-family properties in the ring with the ⅛-mile radius)*(1.136% value effect) + (average number of single-family properties in the rings with the ⅛-mile and ¼-mile radii)*(0.325% value effect)] (2)

The rings are assumed to have the same single-family housing densities as the tract as a whole.[2] Because foreclosures are more likely to occur in those parts of tracts where owner-occupied housing is denser, this assumption yields a conservative estimate of the number of homes that are close to foreclosures.

To provide an even more conservative estimate of the impact of foreclosures on property values, we also performed another calculation that assumes first that there is no effect on properties more than an eighth of a mile from a foreclosure and second that the effect on properties within an eighth of a mile is the smaller 0.907 percent effect shown in the expanded (right-hand side) results of table 2.

Equation (2) and its more conservative counterpart are calculated for every census tract in Chicago. The aggregate impact of foreclosures on one- to four-unit single-family properties in Chicago alone is then estimated by summing these values for all tracts. Under the less conservative assumption, the cumulative impact is estimated to exceed $1.39 billion. The more conservative assumption yields an impact of more than $598 million. Given that there were 3,750 conventional single-family foreclosures in the city in 1997 and 1998, this corresponds to average losses of between $159,000 and $371,000 per foreclosure.

Again, these estimates are only for the effects of 1997 and 1998 foreclosures. Levels have risen considerably since then. Also, these figures do not reflect the effects of foreclosures on all properties, particularly on condominiums, multifamily rental properties, and commercial buildings.

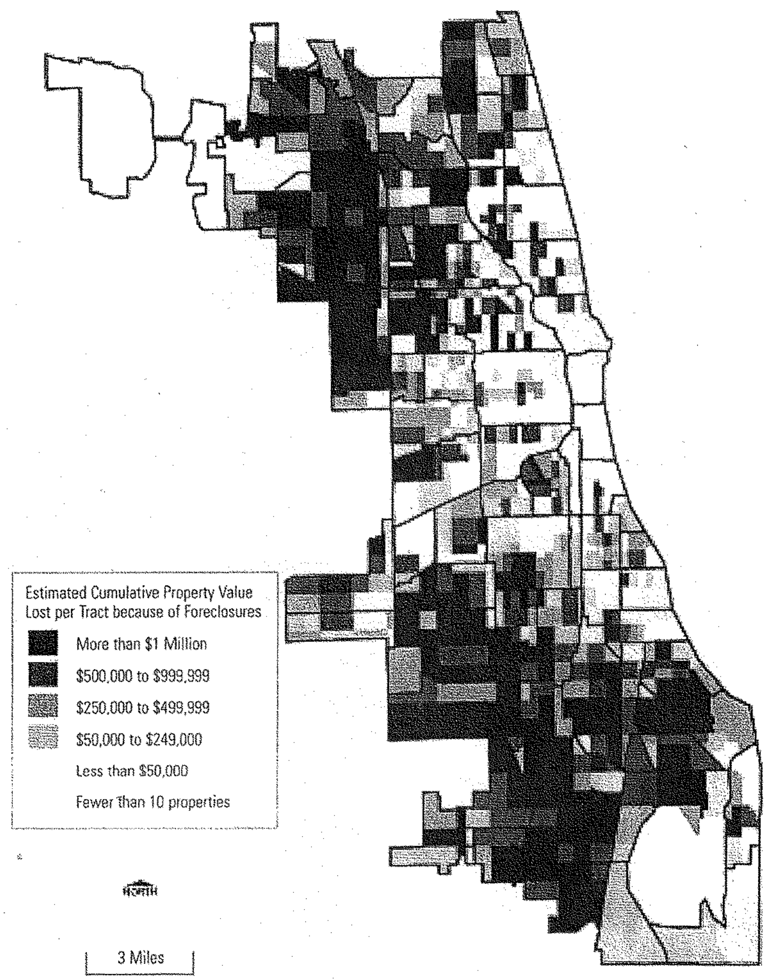
Figure 4 uses the more conservative figure to plot the estimated loss in the value of single-family properties by census tract because of 1997 and 1998 conventional single-family foreclosures. It shows that tracts with the highest levels of lost value tend to be in the south, southwest, and northwest parts of the city. Given the fact that these communities tend to be highly residential and contain mostly detached, single-family homes, this is not surprising. The building stock of neighborhoods closer to the lake and the central city tends to be more dominated by large, multifamily residential buildings and large commercial and industrial structures.

Policy implications and discussion

Foreclosures, particularly in lower-income neighborhoods, can lead to vacant, boarded-up, or abandoned properties that in turn contribute to physi-

[2] The inner ring has an area of 0.04908 square miles, while the outer ring has an area of 0.14727 square miles. The number of properties in these rings is estimated by multiplying the density of the properties in the tract by the corresponding area.

Figure 4. Cumulative Effect of 1997–1998 Foreclosures on Single-Family Property Values, City of Chicago



cal disorder in a community—disorder that can create a haven for criminal activity, discourage the formation of social capital, and lead to more disinvestment. Since foreclosures lead to such negative effects, we would expect them to also lead to lower property values in their immediate vicinity, especially for residential property.

Our findings demonstrate that conventional foreclosures have a statistically and economically significant effect on property values. We provide a relatively conservative measure of such effects by estimating only the effects on single-family properties and excluding condominiums, multifamily rental properties, and commercial buildings. The magnitude of the impact for Chicago is between \$598 million and \$1.39 billion.

These findings have implications for the regulation of subprime mortgage lending, the regulation of the growing segment of exotic mortgage products in the prime market, and policies that aim to expand homeownership to include a broader segment of lower-income households. There are also implications for community reinvestment policy and foreclosure law itself.

First, our findings have clear implications for the regulation of subprime mortgage lending. A variety of recent research demonstrates that foreclosures have been increasingly driven by subprime lending (Goldstein et al. 2005; Immergluck and Smith 2005; Quercia, Stegman, and Davis 2005). Moreover, such foreclosures are exacerbated by the highly concentrated nature of subprime lending in neighborhoods with large minority populations.

If policy makers are to make wise decisions about whether and how much to regulate subprime lending, they must consider not only any benefits or costs that might accrue to the lenders or borrowers who are directly involved, but also the significant costs of foreclosures borne by communities. Most of the residents of the affected communities—many of them lower-income and working-class neighborhoods—have no direct role in the foreclosures occurring around them. There are, of course, strong arguments for regulating market activity when poorly informed or unsophisticated borrowers are harmed by particular lending products or practices. The history of federal and state policy is full of precedents for protecting vulnerable citizens in economic transactions, especially ones as important as mortgage loans. However, when a certain outcome is shown to hurt parties external to the transaction, the arguments for policy intervention and for more direct policy intervention (e.g., limiting or outlawing certain practices versus simply requiring disclosure) become even more robust. Justification no longer depends on the limited financial literacy or impaired understanding of the borrowers. The substantial neighborhood harm caused by high-risk lending should be considered an important cost, regardless of the borrower's ability to make an informed financial decision.

Second, the negative impact of foreclosures on neighborhoods and cities also has implications for the regulation of the exotic, higher-risk prime mortgage products that have grown increasingly popular over the past few years. Interest-only loans, negative amortization products, and combinations of these and other higher-risk loan terms can increase the risk of default even for borrowers with strong credit histories. Moreover, the experience of the subprime market has shown that some of this risk may not be well understood until such loans are exposed to increasing interest rates, a weaker economy, or other adverse conditions.

Third, as Schwartz (2006) and others have argued, U.S. federal housing policy over the past 10 or 15 years has increasingly focused on expanding homeownership opportunities for lower-income and minority households. While this is a laudable goal from several perspectives, one risk of pushing homeownership too hard is that such policies may encourage higher-risk lending and borrowing to the point where costs outweigh benefits. Moreover, the distribution of the costs of higher-risk lending may be disproportionately borne by certain communities or neighborhoods. Of course, the challenge is to develop regulatory regimes that reduce such costs while preserving as many of the benefits of increased homeownership opportunities as possible. In the end, however, some limits on access to homeownership may have to be tolerated if concentrated foreclosures and their impacts are to be held to tolerable levels. The neighborhood costs of foreclosures we have noted suggest that policy makers would be wise to emphasize the sustainability and preservation of homeownership as much as its short-term growth.

Community reinvestment policy can be used to encourage lenders to address the problem of concentrated foreclosures. A number of activities that can be rewarded under the Community Reinvestment Act (CRA) could prove helpful in reducing foreclosures, especially those concentrated in lower-income areas. First, banks can be rewarded in their CRA examinations for offering or participating in the various types of anti–predatory lending programs being offered around the country. Such programs are usually organized by neighborhood-based community development organizations (Higgins 2005). Among those receiving the most attention is the NORMAL program of Chicago's Neighborhood Housing Services. In this program, borrowers at severe risk of foreclosure are provided with more affordable loans to refinance a predatory loan. To compensate for any predatory terms or fees, the payoff to the original lender is less than the outstanding balance. Banks can also receive credit under the CRA Investment or Service Test for supporting foreclosure prevention programs, including postpurchase counseling.

Second, CRA regulators can encourage more responsible lending and thus reduce local foreclosure rates by considering not only the quantity of lending that banks and their affiliates make in lower-income and minority neighborhoods, but also the nature and performance of those loans in bringing about sustainable homeownership. Of course, care should be taken not to adopt practices that might inadvertently discourage responsible lending in lower-income communities.

Reducing high and concentrated foreclosures is a policy objective that will serve the interests not only of consumers and neighborhoods, but of the mortgage banking industry as well. Such an objective is a natural target of bank regulatory policy in that it combines reinvestment and safety and soundness goals. For banks that make loans in impacted communities, concentrated foreclosures could adversely affect their lending markets and their collateral base by depressing property values.

Finally, the impact of foreclosures on property values and neighborhood vitality generally suggests that the nature of the default and foreclosure process itself should be considered. For example, the time that elapses between filing the foreclosure notice and the completed foreclosure sale varies greatly across states. In some states, such as Texas and Georgia, foreclosure periods can be as short as 25 to 35 days, while in others, they can last more than a year. In studying the costs of foreclosures to municipal governments, Apgar and Duda (2005) suggest that streamlining might reduce the negative effects of foreclosures by reducing opportunities for property deterioration and vandalism. Given the potential costs to individual homeowners, more research is needed to determine whether speedier or simpler foreclosure processes are likely to have the desired effects.

This article represents an initial attempt to measure the likely costs of foreclosures on neighborhood property values. More work is needed, including the development of larger databases that include more robust sales data over time. Moreover, additional program and policy development work is needed to identify the most promising methods to reduce foreclosures and to limit the negative impacts of mortgage defaults on neighborhoods and communities. Notwithstanding the need for additional research and program development, the existing evidence on the personal and social costs of foreclosures strongly suggests that policy makers should act aggressively in the near term to stem the continuing problem of high levels of foreclosures that plague so many communities around the country.

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Attachment # 3

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Examining the Rising Foreclosure Rate

Home ownership nationwide has reached a record level: 68 percent of households now own their homes. The latest recession, unlike those of the past, has seen strong home sales, rising home prices, and a generally buoyant housing market. Nonetheless, despite these encouraging trends, foreclosures on home loans are also reaching record highs.

Although the current weak economic conditions might be expected to lead to increased foreclosures, what is surprising is that foreclosures have been steadily escalating for the past twenty years—despite two strong expansions, rising incomes, and generally decreasing unemployment during the same period. The foreclosures involve only a small part of the overall housing market—less than one percent—but they likely signal serious difficulties for a significant segment of homeowners. Moreover, foreclosures raise special concern when they are concentrated in specific areas, particularly central cities, where they may be destabilizing—leading to vacancies and demolitions, damage to neighborhoods, and decline in housing values.

In this issue of *The Regional Economy of Upstate New York*, we examine the foreclosure rate in the U.S. economy and outline factors that may be contributing to its rise. We also investigate the behavior of foreclosure rates in New York State and six of its major metropolitan areas. Particular attention is given to Buffalo, where foreclosures increased fourfold in the 1990s.

While the causes of the escalating foreclosure rates remain unclear, we suggest a link to the increasing number of residential mortgages in which the amount of the loan is high relative to the value of the property. Our analysis of foreclosure rates in New York State indicates that the state rate, though below the national average during the 1980s, exceeded that average in the 1990s. Foreclosure rates in New York's metro areas were also high compared with other metro areas in the 1990s. Finally, our more detailed look at Buffalo's foreclosure patterns reveals a heavy concentration of foreclosures in three "outer-ring" city neighborhoods and a possible connection between the city's declining property values and the sharp increase in foreclosures.

The Foreclosure Process

The record level of home ownership has brought a significant increase in the number of mortgages used to finance home purchases. Not all mortgages, of course, are steadily repaid. When a borrower misses a scheduled payment, the lender cannot know whether the borrower is delinquent—temporarily delaying payment—or in default, stopping repayment altogether. In this situation, the lender must decide whether to work with a delinquent borrower, possibly renegotiating the terms of the loan so that payments can be resumed, or pursue legal foreclosure proceedings to take possession of the property. Thus, the borrower's actions determine if a loan is delinquent, but the lender decides whether to consider the loan in default and initiate foreclosure.

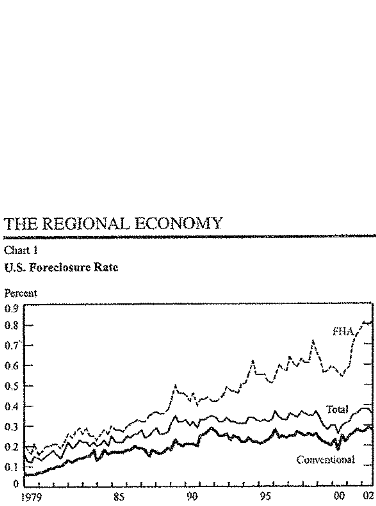
U.S. Foreclosure Trends

The percentage of home loans in foreclosure has generally risen over the past twenty years and, in 2002, reached a record high (Chart 1). Foreclosure rates differ, however, among the three main categories of mortgage loans: Federal Housing Authority (FHA) loans, Veterans Administration (VA) loans, and conventional loans. FHA loans, which account for approximately 14 percent of outstanding mortgages,[1] are insured by the government within specified loan-size limits. Lenders are, by and large, guaranteed against losses. VA loans are insured by the Veterans Administration for qualified veterans, and, like FHA loans, offer lenders protection from losses. Because VA loans account for less than 1 percent of mortgages, however, they are not examined further in this study. Conventional loans, although not insured by a government agency, may be covered by private mortgage insurance purchased by borrowers. Lenders typically require such insurance for loans when borrowers make a down payment of less than 20 percent.

The foreclosure rate on FHA loans has long been higher than that on conventional loans, and the gap between them has widened markedly (Chart 1). The fact that FHA loans tend to be made to a population with a higher

Chart 1

U.S. Foreclosure Rate



Source: Mortgage Bankers Association, National Delinquency Survey.

Notes: The National Delinquency Survey covers 25 million residential mortgage loans. The Mortgage Bankers Association defines the foreclosure rate as loans that entered the foreclosure process during the quarter as a percentage of all loans.

risk profile helps to explain this difference.[2] From 1980 to 1992, the foreclosure rates for conventional and FHA loans climbed steadily, increasing in economic expansions and contractions alike. During these years, the FHA rate doubled, while from 1979 to 1992, the conventional rate quadrupled. Thereafter, however, the rates diverged. While the conventional rate remained flat up through 2002, the FHA foreclosure rate doubled again between 1992 and 2002. Although the percentage of mortgages in foreclosure overall may appear small, the impact of foreclosure can be significant when concentrated in particular neighborhoods. Research on neighborhood effects is scant, but two recent studies in the cities of Buffalo and Rochester have uncovered neighborhood foreclosure concentrations (see box).[3]

Why the Rise in Foreclosures?

The reasons for the long-term increase in the aggregate foreclosure rate are not well understood—no significant studies explain this steady climb. There is, however, a large body of research that addresses the causes of delinquencies and defaults, and to a lesser extent foreclosures, on individual loans.

These studies have focused primarily on the relationship between delinquency or default and the mortgage's loan-to-value (LTV) ratio. The LTV ratio is the amount of the loan divided by the property value. An LTV of 100 percent indicates a loan amount equal to the property value; an LTV of 80 percent indicates that the mortgagee has borrowed 80 percent of the value of the home. LTV ratios may also exceed 100 percent—in particular, when second mortgages or home-equity loans push loan amounts over the value of the mortgaged property.

Virtually every loan study finds a positive relationship between LTVs and loan payment delinquencies, defaults, and foreclosures.[4] The higher the LTV, the less equity a borrower has in the property and therefore the less to lose by defaulting on the loan and losing possession. Moreover, when borrowers with high-LTV loans—particularly loans whose LTV ratios approach 100 percent or more—experience serious financial difficulties or have to move, they may find that default is an economically attractive alternative to selling their property. They may not raise enough funds from the sale of the property to pay off the mortgage, and they will need additional cash to cover the transaction costs of the sale. If these borrowers cannot cover their losses, default may be the only viable option.[5]

Some studies have also posited a link between borrowers' economic difficulties and increased rates of delinquency and default. Foremost among these difficulties are financial crises: interruptions to income, job loss, the death of a spouse, divorce, unforeseen medical expenses, and other emergencies. In addition, high loan payments relative to income have been associated with a higher likelihood of default. Some research also points to increased default rates for low-income borrowers, although other studies fail to confirm this relationship.[6]

Another strand of the literature suggests that foreclosure rates may be influenced by the costs of foreclosure for lenders. After all, the lender ultimately decides whether or not to foreclose, and lenders who choose to take this step will incur expenses for legal proceedings as well as the transaction costs of selling the property. Studies indicate that foreclosure rates tend to be higher in states where laws make the foreclosure process faster and less expensive, such as those states that allow bypassing court-supervised foreclosures for a more streamlined process.[7]

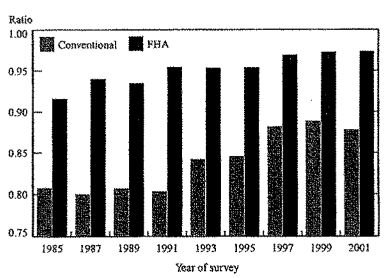
Yet even though these studies offer much insight into the causes of individual foreclosures, none examine the change in the aggregate foreclosure rate over time. Indeed, existing research leaves the long-term increase in the foreclosure rate unexplained. Nonetheless, the findings from loan-level research suggest some preliminary hypotheses about the reason for the rise in aggregate foreclosures.

First, LTV ratios have generally been increasing nationwide over the past twenty years (Chart 2). Loans with low down payments or no down payments and other high-LTV loans have proliferated over the past decade and increased average LTV ratios. Because studies strongly suggest that higher LTV ratios lead to increased foreclosures, it is likely that high-LTV loans have contributed to the burgeoning foreclosure rate.

Explaining the rising foreclosure rate in terms of borrowers' economic circumstances, however, is much more problematic.

Chart 2

Median Loan-to-Value Ratio for U.S. Residential Mortgage Loans

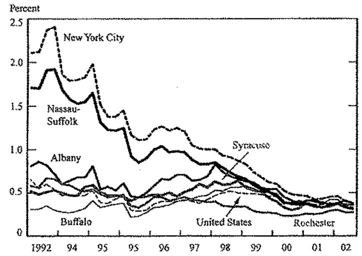


Source: American Housing Survey.

Notes: The loan-to-value (LTV) ratio is calculated as the amount of a loan divided by the value of the property. The ratios plotted are based on loans made in the year of the survey and the year just prior to it. Pre-1985 data matching our criteria were not available. FHA loans are those insured by the Federal Housing Authority.

Chart 3

Foreclosure Rates on Conventional Residential Mortgage Loans: New York State Metro Areas and the Nation



Source: Loanperformance.com.

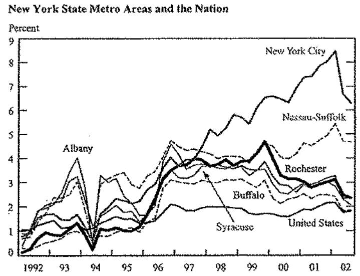
Notes: Loanperformance.com calculates the foreclosure rate as the inventory of loans that are in foreclosure as a percentage of all loans. Data are for prime loans only; subprime loans are excluded. Except for New York City, the metro areas are those defined by the Bureau of the Census; New York City is defined as the five boroughs.

Some factors related to borrower economic status may contribute to increased delinquency and default, but it is difficult to determine precisely how these factors affect the aggregate foreclosure rate without knowing more about the circumstances of those who are delinquent. For example, although economic expansions in the 1980s and 1990s have improved economic circumstances for the broad population, some segments may not be faring as well. Moreover, it is not clear whether a segment of the homeowning population is facing an increased number of economic crises. Another factor may be the increase in low-income home ownership, which rose most significantly in the 1990s. As we have seen, some research suggests that the low-income segment of the homeowning population may be more prone to delinquency and default.[8]

Thus, although research sheds some light on the determinants of individual defaults and foreclosures, extending that analysis to explain the long-term increase in the aggregate foreclosure rate is difficult. Rising LTV ratios have probably contributed to the increase, but we cannot readily evaluate how borrower economic circumstances are changing, and how these changes are affecting loan repayment. Furthermore, the causes of the higher LTV ratios are themselves complex and not well studied. Clearly, careful and comprehensive research is needed to control and isolate the effects of a multitude of factors on the foreclosure rate to better understand the forces behind its rise.

Chart 4

Foreclosure Rates on FHA Residential Mortgage Loans: New York State Metro Areas and the Nation



Source: Loanperformance.com.

Notes: Loanperformance.com calculates the foreclosure rate as the inventory of loans that are in foreclosure as a percentage of all loans. FHA loans are those insured by the Federal Housing Authority. Data are for prime loans only; subprime loans are excluded. Except for New York City, the metro areas are those defined by the Bureau of the Census; New York City is defined as the five boroughs.

Table 1

Forecloure Rates for Selected Metropolitan Areas, 1992-2002

	Total	FHA Rank	Conventional Rank		Total	FHA Rank	Conventional Rank
Riverside	1.35	11	7	Sta Barbara	0.45	74	28
Newark	1.33	1	3	San Diego	0.44	71	36
Orange	1.32	3	1	Phoenix	0.44	61	45
New York	1.26	2	2	Dayton	0.42	41	50
Monmouth	1.24	8	4	Akron	0.41	21	51
Nassau-Suff.	1.07	4	8	Pittsburgh	0.40	44	46
New Haven	1.05	10	9	San Antonio	0.39	80	58
Berg-Passaic	1.04	13	6	Houston	0.39	72	42
Scranton	1.02	6	5	Richmond	0.39	40	80
Los Angeles	0.94	14	10	Tulsa	0.38	65	52
Philadelphia	0.93	5	16	Atlanta	0.38	45	61
Miami	0.88	16	14	Redding	0.38	58	43
Albany	0.88	18	15	Salt Lake Cty	0.38	59	57
Syracuse	0.84	15	22	Sta Rosa	0.37	69	39
Orlando	0.80	24	18	Chico-Yuba	0.36	76	49
Hartford	0.80	25	12	Greenville	0.36	46	53
Middlesex	0.80	27	11	Spokane	0.36	64	60
Allentown	0.79	9	17	Birmingham	0.35	52	75
Jacksonville	0.76	34	26	Nashville	0.35	53	79
Memphis	0.72	28	62	Oakland	0.35	66	38
New Orleans	0.70	29	29	Toledo	0.35	22	56
Rochester	0.68	12	25	Charlotte	0.34	51	65
Fairfield	0.68	20	13	Cincinnati	0.32	36	68
Fresno	0.68	42	31	St Louis	0.32	48	64
Norfolk	0.68	37	69	Louisville	0.29	62	70
Tampa	0.65	30	24	Tucson	0.29	81	67
W. Palm Beach	0.63	19	21	Kansas City	0.28	67	73
Baltimore	0.61	26	54	Minneapolis	0.27	68	77
Las Vegas	0.61	50	37	Greensboro	0.27	70	74
Honolulu	0.60	32	19	Monterey	0.25	79	59
Cleveland	0.60	7	35	Seattle	0.25	75	71
Modesto	0.59	49	27	Austin	0.24	82	78
Buffalo	0.58	31	32	Raleigh	0.22	63	83
Anaheim	0.53	43	20	Milwaukee	0.22	38	76
D.C.	0.53	35	47	Portland	0.21	78	72
Sacramento	0.52	56	33	Knoxville	0.21	77	85
Chicago	0.52	17	41	Denver	0.20	83	82
Columbus	0.50	23	44	San Jose	0.20	85	63
Boston	0.50	73	23	San Francisco	0.19	86	66
Indianapolis	0.50	33	55	Detroit	0.19	54	81
Okla. City	0.50	60	40	Omaha	0.18	84	84
Providence	0.47	39	34	Grand Rapids	0.16	55	86
Worcester	0.46	47	30				
Dallas	0.45	57	48	**U.S.**	**0.54**	**38**	**29**

Source: Loanperformance.com.

Notes: The foreclosure rate is calculated as the average of all quarterly rates from 1992 through the third quarter of 2002; data are collected on these 86 metro areas only.

Foreclosures in New York State

The foreclosure rate in New York State exceeded the national average for most of the 1990s, after remaining below average throughout the 1970s and 1980s. The rate rose dramatically during the 1990-91 recession—more than doubling between 1990 and 1992. That period saw a severe state recession that for some areas lasted into the early 1990s. Overall, New York State's foreclosure rate ranked forty-fourth in the nation in the 1980s, but ninth in the nation in the 1990s.

To examine foreclosure rates within New York State, we use local foreclosure data collected by Loanperformance.com, an agency that collects loan data covering approximately 70 percent of the aggregated U.S. residential mortgage market. Data are available from 1992 to 2002 for eighty-six metropolitan areas, including New York City, Nassau-Suffolk, Buffalo, Rochester, Albany, and Syracuse.[9]

Foreclosure rates for New York's metro areas were generally above the national rate during the ten-year period. The foreclosure rates for New York City and Nassau-Suffolk were among the ten highest rates for the eighty-six metro areas studied (see table). Albany and Syracuse also ranked high, with Rochester and Buffalo ranking lower but above the national rate. FHA foreclosure rates in New York State were higher than conventional rates—the same pattern observed at the national level. While FHA foreclosure rates increased during the period, conventional foreclosure rates fell (Charts 3 and 4).

Downstate, the conventional foreclosure rates for New York City and Nassau-Suffolk were more than double those for most of the upstate metro areas during the early 1990s, but they fell steadily throughout the decade (Chart 3). Foreclosure rates for upstate metro areas fell slightly from 1992 to 1995, increased from 1995 to 1998, then increased throughout 2002. Conventional foreclosure rates for upstate and downstate metro areas converged and were essentially equivalent by 2000.

FHA foreclosure rates have behaved quite differently than conventional rates, climbing throughout much of the 1990s (Chart 4). In particular, all areas showed a sharp increase in these rates beginning in 1996. And while foreclosure rates flattened in the late 1990s for upstate metro areas, they continued to climb in New York City and Nassau-Suffolk. In New York City, the FHA foreclosure rate in 2002 was four times the national rate

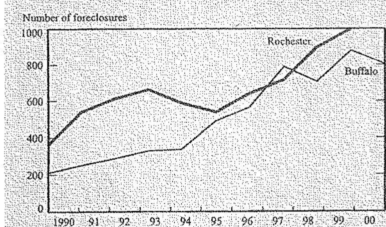
continued on last page

Foreclosures in the City of Buffalo

Although the percentage of home loans that end in foreclosure has remained relatively small, the trends underlying the national and regional rise in foreclosures are worrisome. Recent studies of foreclosures in Rochester and Buffalo, conducted by the Rochester Housing Council and the Buffalo Branch of the Federal Reserve Bank of New York, indicate that during the 1990s, foreclosures quadrupled in both cities (see chart). Moreover, these increases were heavily concentrated in particular neighborhoods. In this box, we look more closely at the key findings of our study of foreclosures in Buffalo.[1]

We detected two patterns in the geographic distribution of foreclosures in the city (Exhibits 1 and 2). First, foreclosures increased dramatically in all parts of the city from 1990 to 2000. Second, foreclosures tended to spread into the outer ring of the city in clusters. By the year 2000, foreclosures were densely concentrated in three outer-ring neighborhoods—the Northeast, East Delavan, and the West Side. To understand the genesis of these patterns, we matched neighborhood foreclosure rates with housing market characteristics and socioeconomic data and examined loan-level data in a sample of foreclosures.

Residential Foreclosures in Buffalo and Rochester, 1990-2000



Sources: *Buffalo Law Journal*; Rochester Housing Council.

Declining Property Values

Like many cities, Buffalo has some of the oldest housing in its metropolitan area and shows little growth in new homes.[2] The city has 28 percent of the metro area's housing, yet more than half of the region's pre-1939 housing stock and half of its housing vacancies. The city and metro area are losing population, and the city's share of the metro area's population has been declining. While the region has gained housing units, the city has experienced both a loss of housing units and an increase in vacancies.

An important consequence of the reduced demand for city housing is a broad decline in property values (Table 1). Between 1998 and 2002, the median home price for existing-home sales dropped in most Buffalo neighborhoods and, in the city overall, fell 13 percent.

Such declining property values have, in turn, led to higher loan-to-value (LTV) ratios, an outcome strongly associated with a rise in foreclosures. In 2000, the median LTV of a foreclosed property in the city of Buffalo at the time of foreclosure was 119 percent.[3] In other words, the amount of the loan exceeded the value of the property by a significant margin. Homeowners in this predicament find that if they attempt to sell their homes, the funds raised will not cover the balance of the loan. Foreclosure will likely leave the homeowner in a better financial position than selling and may be the only viable option if there are no other funds available to cover the balance due.

Socioeconomic Characteristics of Foreclosures

In the Buffalo study, we examined foreclosure patterns in 2000 in relation to a number of neighborhood socioeconomic characteristics. We found that foreclosure rates were generally highest in city areas with higher incomes—although these areas had incomes well below the metro area overall. Fifty-nine percent of all foreclosures were in higher-income census tracts. The foreclosure rate for stable higher-income tracts—meaning those that saw no significant change in income level from 1990 to 2000—was 0.64 percent, somewhat higher than the 0.44 percent rate for stable lower-income tracts. In addition, tracts that experienced a large decline in income experienced relatively high foreclosure rates.

Sixty-three percent of foreclosures occurred in minority census tracts, with the remaining 37 percent taking place in nonminority tracts. Furthermore, the highest foreclosure rates occurred in areas undergoing a change in racial composition, particularly a change from a white to a minority population. In these areas, the foreclosure rate was nearly double the citywide average. Census data indicate that the minority population is generally moving outward, with the greatest increase in minority population occurring in a concentric ring around the outer edges of the city. These foreclosure patterns mirror the patterns identified in a Fannie Mae study of New Orleans home loans.[4]

Characteristics of Foreclosed Loans

We also examined detailed loan records to determine the specific characteristics of foreclosed loans. We found that 38 percent of foreclosures were on homes with Federal Housing Authority (FHA) mortgages, even though FHA loans account for only 14 percent of mortgages nationwide. This result reflects both more FHA lending in the city than the nationwide average and the higher foreclosure rate on FHA loans. Most of the foreclosures were on mortgages that were used for a direct purchase, with only about one-third on mortgages used for refinancing loans. Most foreclosures occurred on relatively young loans; the average age of the loans when foreclosure proceedings were started was 5.6 years. In addition, we found that foreclosures were nearly evenly split between owner-occupied and investor-owned properties. Owner-occupants, however, foreclosed at approximately a 50 percent faster rate, and new homeowners accounted for the majority of foreclosures.

Table 1
City of Buffalo Housing Market, 1998-2002

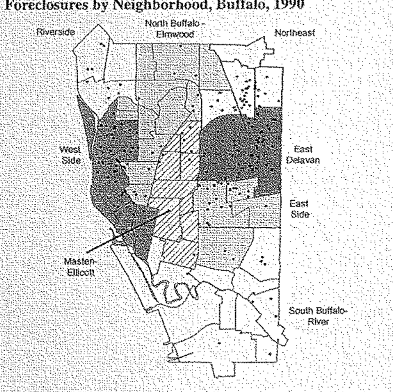
	Existing Home Sales Percentage Change	Median Home Price Percentage Change	Median LTV in 2000 (Percent)	Foreclosure Rate in 2000 (Percent)
N. East	26	-11	119	1.03
E. Delavan	14	-37	125	0.96
East Side	44	-25	159	0.56
Riverside	46	-6	124	0.49
S. Buffalo-River	33	-15	110	0.48
W. Side-Central	75	-54	105	0.47
Ellicott-Masten	103	0	153	0.32
N. Buffalo-Elmwood	41	5	112	0.22
Buffalo total	35	-13	119	0.53

Sources: Buffalo Association of Realtors' City of Buffalo.
Notes: Because overall loan data were unavailable for the city, we defined the foreclosure rate as total foreclosures divided by total housing units. The first year that data on median home prices by neighborhood were available was 1998, see footnote 3 regarding the computation of LTV.

The Buffalo study will be published by the Buffalo Branch of the Federal Reserve Bank of New York in June. Visit www.newyorkfed.org for more details.

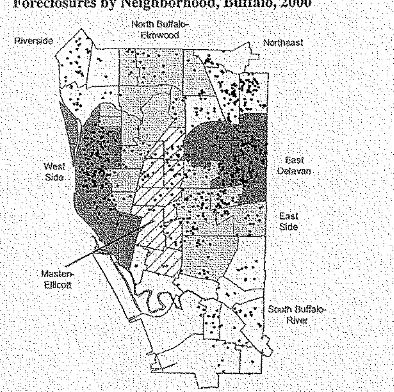
Notes:
[1] Foreclosure data were gathered from individual records from the *Buffalo Law Journal*, the Erie County Clerk's office, and the City of Buffalo; some of the results presented are based on samples. For further details on methodology, see the complete report.
[2] The Buffalo metropolitan area consists of Erie and Niagara counties.
[3] Technically, our measure is not the median LTV ratio but the median judgment relative to the value of the foreclosed property. The judgment is the amount homeowners owed on their mortgages at foreclosure, and includes the outstanding balance on the loan's principal, plus interest, attorney and court fees.
[4] See Mickey Lauria, "A New Model of Neighborhood Change: Reconsidering the Role of White Flight," *Housing Policy Debate* 9, no. 2 (1998): 395-424.

Exhibit 1
Foreclosures by Neighborhood, Buffalo, 1990



Sources: City of Buffalo, Division of Planning, Buffalo Law Journal

Exhibit 2
Foreclosures by Neighborhood, Buffalo, 2000



Sources: City of Buffalo, Division of Planning, Buffalo Law Journal and, in Nassau-Suffolk, double the national rate. Overall, during the period from 1992 to 2002, New York City had the second-highest average FHA foreclosure rate of the eighty-eight metro areas studied. FHA foreclosure rates for New York State's metro areas ranked in the top quartile during the period from 1992 to 2002—with the exception of Buffalo.

Given the lack of research explaining the increase in foreclosures at the national level, it is difficult to assess the causes and pattern of New York State's relatively high foreclosure rates. Nonetheless, studies of foreclosures in Buffalo and Rochester suggest that property values have declined in the central cities of upstate metro areas. This decline has contributed to high LTV ratios and, in some cases, negative equity (see box). More detailed data on the geographic location and specific characteristics of foreclosures in individual metro areas, however, will be necessary to understand the sources and behavior of foreclosures in New York State.

Conclusion

The U.S. foreclosure rate has been rising steadily for the past twenty years, reaching a level of 0.37 percent in 2002. Our analysis indicates that New York State has had an above-average foreclosure rate since the 1990-91 recession, with New York City and Nassau-Suffolk ranking particularly high among a peer group of metro areas from 1992 to 2002.

While research addressing the causes of rising foreclosure rates is negligible, the importance of understanding these causes is great, because foreclosures may well affect particular segments of homeowners disproportionately. Foreclosure studies in the cities of Rochester and Buffalo, for example, have uncovered significant concentrations of foreclosures in specific neighborhoods. Further research into the causes and impacts of these trends is surely needed to identify effective responses to the clustering of foreclosures and the continued rise in the foreclosure rate.

Notes:

[1] U.S. Census Bureau, American Housing Survey, 2001.

[2] FHA borrowers tend to be younger, more credit-constrained, and live in areas with below-average incomes; see Harold Bunce et al., An Analysis of FHA's Single Family Insurance Program (Washington, D.C.:, U.S. Department of Housing and Urban Development, Office of Policy Development and Research, 1995).

[3] For an example in New Orleans, see Mickey Lauria, "A New Model of Neighborhood Change: Reconsidering the Role of White Flight," Housing Policy Debate 9, no. 2 (1998), 395-424.

[4] For a comprehensive review of these studies, see Roberto Quercia, "Residential Mortgage Default: A Review of the Literature," Journal of Housing Research 3, no. 2 (1992): 341-79.

[5] Default likely affects credit history, however. Borrowers who choose this course must reckon with this additional cost.

[6] See Nicolas Retsinas and Eric Belsky, eds., Low-Income Homeownership: Examining the Unexamined Goal (Washington, D.C.: Brookings Institution, 2002); and Roberto Quercia, "Residential Mortgage Default."

[7] See Terrence Clauretee, "The Impact of Interstate Foreclosure Default Differences and the Value of Mortgages on Default Rates," American Real Estate and Urban Economics Association Journal 15, no. 3 (1987). New York State does not allow such nonjudicial foreclosures.

[8] See, for example, Belsky and Duda, "Anatomy of the Low-Income Homeownership Boom in the 1990s," in Low-Income Homeownership: Examining the Unexamined Goal.

[9] The data from Loanperformance.com cover only prime loans; subprime loans, made to those with poorly established credit or banking histories, are excluded. In this regard, the data differ from the Mortgage Bankers Association (MBA) foreclosure data. Moreover, Loanperformance.com tracks the inventory of loans in foreclosure, while MBA tracks only those loans that entered the foreclosure process during the immediate quarter. For this reason, the foreclosure rates calculated by Loanperformance.com will tend to be higher than those estimated by MBA.

Richard Deitz and Ramon Garcia

Research support was provided by Anthony Kurdziel

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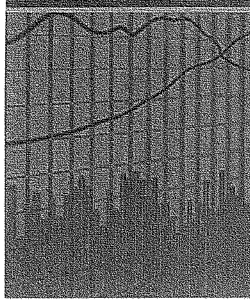
Attachment #4

» INSIGHTS

FICO



FICO Score Trends in Today's Economic Uncertainty

New study explores changing risk dynamics and how lenders can respond

Number 18—July 2009

As changing economic conditions continue to challenge financial institutions worldwide, many risk managers are trying to make sense of evolving bureau risk score trends and dynamics.

Many have turned to FICO with questions like: Are scores accurately reflecting increasing risk? Why is a 700 FICO® score performing like a 670? Are consumers scoring lower given increases in delinquency rates? Should I alter my cutoff given the riskier environment?

FICO conducted an analysis on recent bureau data to better understand potential changes in risk dynamics. Key findings included:

FICO conducted an analysis on recent bureau data to better understand FICO® score trends and potential changes in risk dynamics. This paper highlights the most significant findings and provides guidance for best practices.

- **FICO® scores continue to rank-order risk**—in other words, the higher the score, the lower the risk. This holds true on the general population, for industry segments (bankcard, auto and mortgage) and over time.
- **FICO® score distributions have remained relatively stable over time** for the general population. There is a slight movement toward the lower and higher ends of the score range in more recent time periods.
- **FICO® scores do move when there's a meaningful change in credit behavior.** If a consumer experiences a job loss or other hardship, for example, the FICO score reflects higher risk when the consumer's credit behavior itself changes and that change is reflected in their credit file.
- **The odds-to-score relationship has remained relatively stable** over time on the general population.
- **More recent data samples reflect increased consumer risk** when looking at various industry verticals. This is especially noticeable on the more recent mortgage vintages, reflecting the current stress of that industry segment.

This paper will explore these findings in more detail, answer common questions about FICO® score performance, and discuss best practices for using and tracking FICO scores.

FICO

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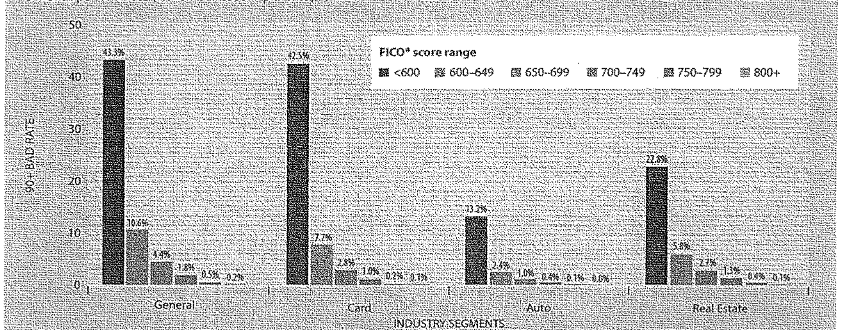
» Does the FICO® score still assess risk effectively?

The FICO® score is designed to rank-order risk, and research shows that it continues to do so in the current economic climate. The scores remain an effective tool to help lenders identify consumers more likely at risk of default or too risky for new credit extension.

Research results show that higher-scoring consumers demonstrate better future performance (lower bad rates or more favorable odds) compared to consumers who score lower. This rank-ordering holds true for different industry segments (e.g., auto, mortgage, credit card, retail), across different time periods, as well as for different account sourcing strategies (direct mail, retail branch, internet) and product terms (30 year fixed, 5 year ARM).

Figure 1 illustrates this concept by industry segment. Consumers with an existing auto, bankcard or mortgage credit obligation are scored as of October 2008, and their performance is measured for that credit product over the subsequent six-month window.

Figure 1: FICO® scores continue to rank-order risk
90+ Bad Rate by Industry
6 month performance (November 2008–April 2009)



The validation results show that those consumers identified as high risk by the FICO® score resulted in higher bad rates compared to those identified as lower risk. This holds true for the general population, as well as for credit cards, auto loans and mortgages.

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» Why is a 700 FICO® score performing like a 670? Isn't performance fixed by score?

The results in Figure 1 show that while the FICO® score effectively rank-orders risk within each industry segment, actual bad rates differ by industry segment.

This calls attention to a misconception in the industry—that performance (bad rate or odds-to-score ratio) by FICO® score range is static or "fixed" by design to always equate to the same result. For example, a FICO score of 700 will always equate to a 2% bad rate over time, across portfolios, lenders and credit products/product terms; or that the odds-to-score relationship doubles every 20 points on the FICO score scale.

However, the broad-based FICO® score is not designed to have a fixed performance at a given score.

Actual portfolio performance by score is unique by lender, driven by its targeting/marketing strategies and customer treatment approaches. In addition, macro-level events—such as changes in the economy, home prices or unemployment trends—may also impact consumers' credit behaviors and associated credit performance by score range.

For this reason, it is extremely important that all lenders conduct frequent monitoring and score validation analysis to understand performance dynamics for their overall portfolio and population segments of interest. The results of this analysis may indicate a need to adjust how FICO® scores are used within targeting, underwriting and customer management strategies.

FICO regularly analyzes FICO® score performance to help lenders identify industry-wide changes and trends in risk behavior. The next section provides insight on the most noteworthy trends in the current economic downturn.

» Is FICO® score performance changing given today's economy?

Given current economic challenges in the US economy, there is a continued industry interest in understanding how FICO® scores are performing. We analyzed data from 2005–2009 to better understand how FICO scores are trending over this time period. We looked at score distribution and score performance dynamics at the national level, as well as for various population segments of interest.

Score Distribution Trends

At an individual consumer level, the FICO® score is based on the most up-to-date information contained in a consumer's credit report at the time a request is made for the FICO score and credit report. The consumer's FICO score can change as information in the consumer's report changes. The more "dramatic" the change in the new information reported, the more impact it will have on that individual's score.

On a national level, the distribution of FICO® scores has remained relatively stable over time. Most US consumers continue to pay their credit obligations on time, are not heavily indebted and only apply for new credit when needed.

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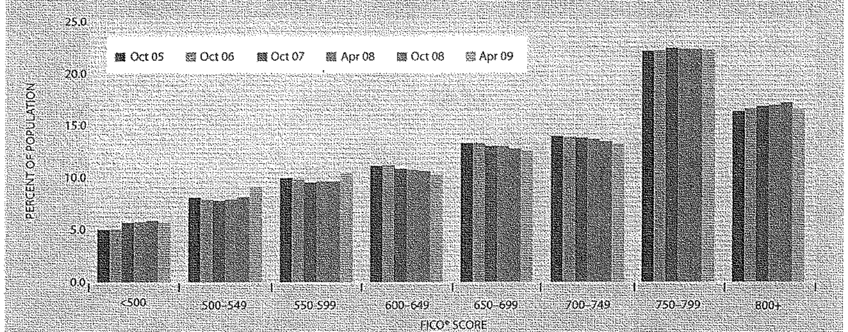
However, as illustrated in Figure 2, there is a slight movement of population to both the higher and lower tail ends of the score range in the more recent time periods.

Figure 2: Score distributions remain stable, with slight shifts at extremes
General Population
Interval Score Distribution (2005–2009)



At first, it may seem counter-intuitive that FICO® scores are increasing for any consumers, given that lenders are reporting higher levels of delinquency and unemployment is rising. What the data alludes to is that many risk-averse consumers are actually "retrenching" their credit activity—paying down balances and applying for less credit. In essence, these consumers are "tightening their belts" in anticipation of harder economic times, resulting in upward score movement for a percent of the population.

As expected, there is more movement into the lower scores, as a growing segment of the population struggle to make credit payments on time and build up credit balances. The score can decrease when negative information hits the consumer's credit file, such as from credit behavior changes due to loss of income (recently unemployed, for example) or the inability to pay a recently increased adjustable-rate mortgage.

Some lenders may question why they are not seeing a more pronounced shift towards lower scores, given overall higher industry loss rates and increasing unemployment.

A FICO® score will change and reflect a different level of risk if a "trigger event" (i.e., a job loss or severe medical hardship) drives consumers to alter the way they manage their existing credit and/or seek new credit. By how much and when will be unique for each consumer based on how they respond to that trigger event and when that new behavior gets reflected in their credit file.

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It's important to note that FICO® scores do not have access to information on the trigger events themselves—only when the event triggers a change in credit behavior. For example, a consumer's employment status, level of income or depreciation of home value could provide predictive insight in understanding a consumer's overall risk dynamic. These items are not considered in the FICO score calculation because these data elements are either unreliably reported or not available on the consumer's credit file.

In addition, while delinquency rates have increased in more recent times, the majority of US consumers continue to meet their credit obligations on time. The vast majority of delinquencies originate from lower-scoring consumers. The incremental delinquency will have less dramatic impact on score movement when it occurs on a file where late payment behavior already exists.

Score Distribution Trends—distressed consumers

To further understand score distribution impacts under the current environment of increased risk, we analyzed the score movement for consumers who experienced some sign of financial duress. This was measured by the appearance of new delinquency or substantial increased debt utilization between November 2008 and April of 2009.

Our analysis showed that 26% of all consumers experienced some level of financial duress during this period, as illustrated in Figure 3. The majority of these consumers—66% (17.17% of the 26%)—who experienced this new duress activity were already scoring 640 or lower. Only 14% of consumers who experienced new duress were in higher-scoring bands (720+).

Figure 4 illustrates the impact this duress activity had on the consumers' FICO® scores as of April 2009. This is measured by average change in FICO score over the six-month period.

The new delinquency and increased debt utilization had a downward impact, on average, for all scores. The degree of impact is much greater, on average, for those consumers who were initially scoring in the high ranges before the new credit behaviors were reflected in the credit file.

Changes in score distributions can provide early insight into emerging problems—and opportunities—that lenders can explore more fully before taking action. We strongly recommend that lenders track and evaluate score distribution trends on their own applicants and customers as a whole, as well as on various sub-segments of interest.

Even better, coupling score distribution monitoring with review of other data elements (unemployment or home value movement, for example) provides a more complete understanding of the potential risk dynamics taking place within your environment.

Figure 3: Majority of distressed consumers score 640 or lower
Presence of New Sign of Duress by Score Band at October 2008

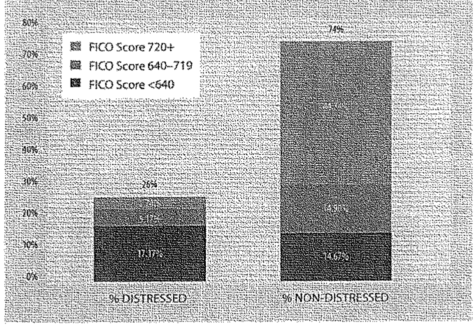

Figure 4: Impact of financial duress on FICO® scores

Consumers with new delinquency and/or substantial increase in revolving utilization by FICO score band	Average change in FICO score (Oct 08–April 09)
<640	–6 points
640–719	–36 points
720+	–46 points
Total Population	–18 points

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Score Performance Trends

We know that delinquency rates are rising overall and for most lending segments. Are risk trends (bad rates or odds) by FICO® score also changing?

To understand overall risk trends by FICO® score, we analyzed FICO score performance by comparing 6-month performance based on October 2007–April 2008, April 2008–October 2008, October 2008–April 2009 credit bureau data samples.

We used odds-to-score rankings to explore how relationships differed over the time periods. In other words, at a given score, are the odds (90+ days past due) continuing to shift higher, and if so, by how much?

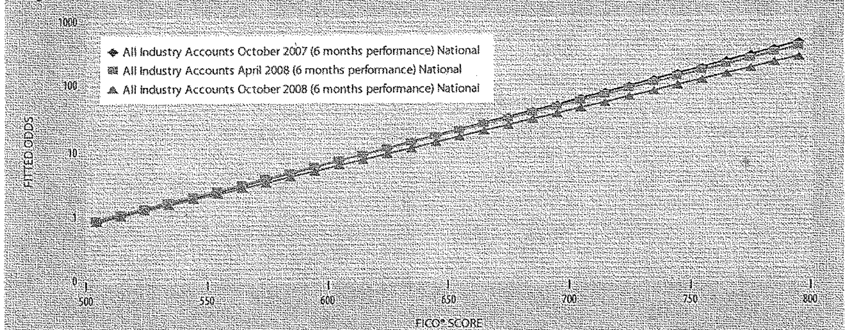
The results support what the industry has been reporting—that US credit risk has indeed continued to rise industry-wide, as well as within bankcards, auto and mortgage lending segments. The change in odds at a given score range is most pronounced within mortgage. This is not surprising given the particular stress within that industry segment.

Figure 5 shows the odds-to-score relationship for the general population for all three time periods analyzed.

Figure 5: Industry-wide risk trends

General Population

Alignment Plot



As the chart illustrates, the odds-to-score relationship has remained relatively stable over time. However, risk has increased slightly in the most recent vintage. While the two earlier periods remained relatively steady, there was a slight shift of approximately 12 points in odds at a given score in the most recent sample. For example, a 700 in the most recent sample is performing more like a 688 in previous vintage.

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Figures 6 and 7 show this same graph, but for existing bankcard and auto loan industry segments.

Figure 6: Bankcard risk trends
Bankcard Segment
Alignment Plot

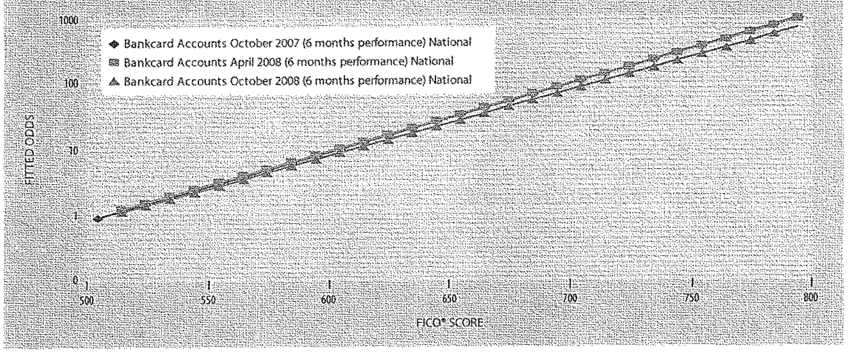
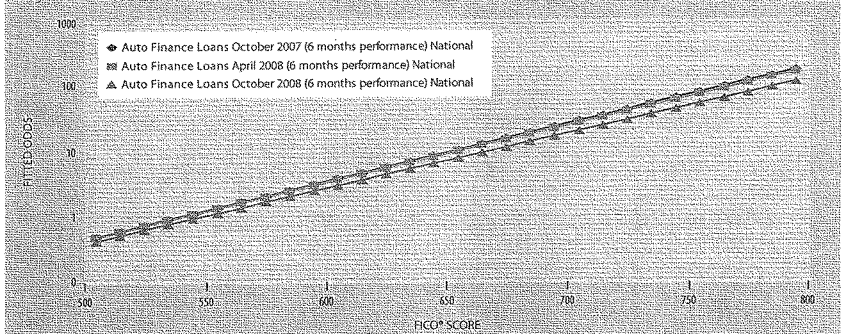


Figure 7: Auto risk trends
Auto Loan Segment
Alignment Plot



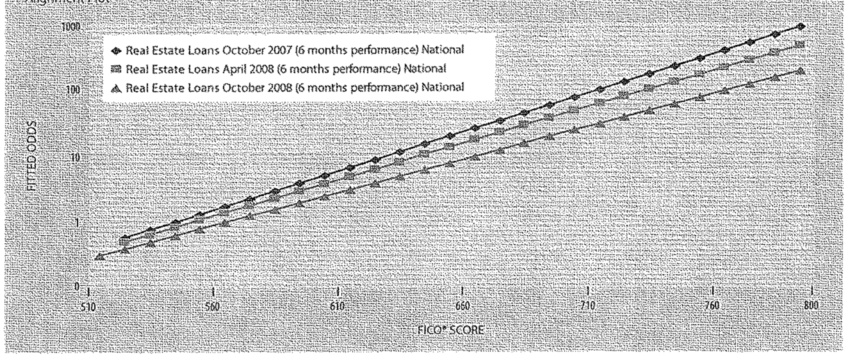
» INSIGHTS

As with the general population, the odds-to-score relationship has remained relatively stable over time for both bankcard and auto loan segments. However, risk has increased slightly in the most recent vintage in the bankcard segment and more noticeably in the auto lending segments:

- In bankcard, there was a slight shift of approximately 11 points in odds at a given score in the most recent sample. Thus, a 700 in the most recent sample is performing more like a 689 in previous vintages.
- In auto loan, there was a slight shift of approximately 15 points in odds at a given score in the most recent sample. Thus, a 700 in the most recent sample is performing more like a 685 in previous vintages.

Figures 8 show this same graph, but for the existing mortgage segment.

Figure 8: Mortgage risk trends
Mortgage Segment
Alignment Plot



The chart shows that the more recent samples are noticeably more risky compared to prior vintages across the score range. The increased risk trend is more pronounced compared in the general population and other industry segments. There is a shift of approximately 17 points in odds at a given score between the two earlier samples and more than 30 point shift in odds at a given score between the two most recent samples.

These results could be a reflection that general mortgage lending practices (guidelines related to doc/verification/down payment, DTI ratios, etc.), home price values and access to refinancing options have changed drastically in the most recent time periods.

While the overall risk has increased in more recent vintages and the odds/bad rate by score have changed, these results also illustrate that the FICO® score continues to rank-order risk in each of the three time periods and for each industry segment.

» INSIGHTS

» What are scoring best practices during uncertainty?

Whether in a period of economic growth or uncertainty, smart risk management practices remain essential. Lenders should continue evaluating and testing existing credit policy risk controls.

- Lenders should closely track and **monitor portfolio performance by score**, and make adjustments accordingly.
- Given today's market, it's especially important to **evaluate portfolios by vintage and local economic factors**. If something looks unusual or a vintage isn't performing as expected, it is a red flag for lenders to tighten customer management in those risky areas—and to reevaluate targeting approaches and underwriting criteria.
- More **frequent score refreshes**, even among collateralized products, could identify losses earlier and signal a need to re-evaluate portfolio performance. We recommend at least quarterly account management updates.
- **Stronger risk tools** can also help. Validation results show that the latest release of the FICO® score, FICO® 08, increased predictive power in higher-risk segments, including credit shoppers and nonprime borrowers.

While credit bureau data and scores are highly predictive, good underwriting and customer management consider a broader view of risk. Risk factors not captured by bureau data, such as fraud or even product terms, can also impact portfolio performance.

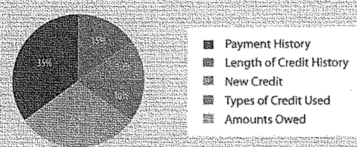
While lenders need to remain risk vigilant, the reality is that they also must be able to grow and pursue new opportunities—often even more difficult in times of uncertainty.

That's why we recommend using risk management tools and techniques that permit lenders to better calculate risk vs. reward—like champion/challenger testing to evaluate and refine strategies before rolling them out to a broad customer base. Lenders can evaluate which products and terms to offer, and which underwriting criteria, scores and external data are most useful in strategies, under varied market conditions for different consumer segments.

What's in a FICO® score?

FICO® scores summarize the real-time information in consumers' credit files and rank-order consumers according to risk of default on a 300–850 scale, where higher scores equate to lower future risk.

FICO® scores assess the person's credit history as represented on their credit report. Their history can be split into five data categories. The chart reflects how important each category is when calculating scores for the general population. This credit information is typically the same items a lender would use to make a credit decision.



FICO® scores consider trade line, inquiry, collections and public record information. Information from other parts of the credit bureau report, including occupation, income and length of time at present address, is not used as predictive variables in the score. In addition, FICO scores do not consider data prohibited by Regulation B of the Equal Credit Opportunity Act, including race, color, religion, national origin, sex, marital status or age.

Additional information on what's considered by the FICO® score can be found at the *Credit Education Center* on myFICO.com.

» INSIGHTS

Stronger measures of consumer credit capacity can also help lenders identify new opportunities with less risk. FICO® Credit Capacity Index™ is a forward-looking analytic measure that, when combined with FICO® scores, determines, "For consumers who look equally risky, who can more safely manage additional credit?"

Balancing business growth and risk management, while tricky, certainly continues to be business-critical. Those who do it best are most likely to ride out the market fluctuations and challenges like those we face today.

FICO will continue to validate FICO® scores and underlying risk trends, and dig deeper on key scoring topics in future Insights papers. For more information, contact us at 800-777-2066 or *cbhelpline@fico.com*, or subscribe to our Insights white papers at *www.fico.com/insights*.

The Insights white paper series provides briefings on research findings and product development directions from FICO. To subscribe, go to *www.fico.com/insights*.

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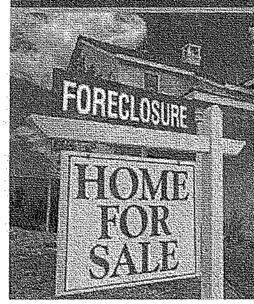
Attachment #5

» INSIGHTS

FICO



Are today's market pressures reshaping credit risk?

New study explores FICO® score trends in dynamic times—and how lenders can respond

Number 3 — May 2008

In turbulent economic times, financial services firms often tighten the credit reins and refocus on risk. But with growing consumer debt and continued fallout from the credit crisis, many are questioning the effectiveness of today's lending strategies.

As rising debt leads to defaults, financial services clients are turning to FICO with concerns such as: Why are my delinquencies increasing, even for lower-risk segments? Why is a 680 FICO® score performing like a 650?

FICO conducted a performance analysis to understand potential changes in FICO® score risk patterns. This paper highlights the most significant findings and provides guidance for best practices.

This begs the broader question: Are today's economic pressures changing the credit risk patterns underlying FICO® scores—and if so, how should lenders respond?

FICO set out to understand and quantify potential changes in risk dynamics. We conducted a FICO® score performance analysis, comparing data samples across several time periods reflecting different economic conditions. This paper highlights our most significant research findings and provides guidance for best practices, given what we saw.

» Research results: key takeaways

Lenders experiencing increased delinquencies should know that they are not alone. Our performance analysis showed:

- **Consumer risk is rising industry-wide**, across lending products and score ranges.
- **Segments with the greatest risk increases largely reflect market pressures.** We see greater risk, for instance, for new mortgage accounts, and select states hit harder by unemployment, falling home prices and speculative investing. These groups are likely impacting overall portfolio charge-off rates.
- **Despite increasing risk, many risk predictors remain stable—with notable exceptions.** Consumers with multiple mortgages, for example, are still less risky than those with none or fewer mortgages—but are comparatively riskier than before. Later in the paper, we'll discuss the more pronounced changes to risk indicators that lenders should keep an eye on.
- **FICO® scores continue to rank-order risk**—in other words, the higher the score, the lower the risk. This holds true on a general population, as well as specifically for bankcards, auto and mortgage risk prediction.

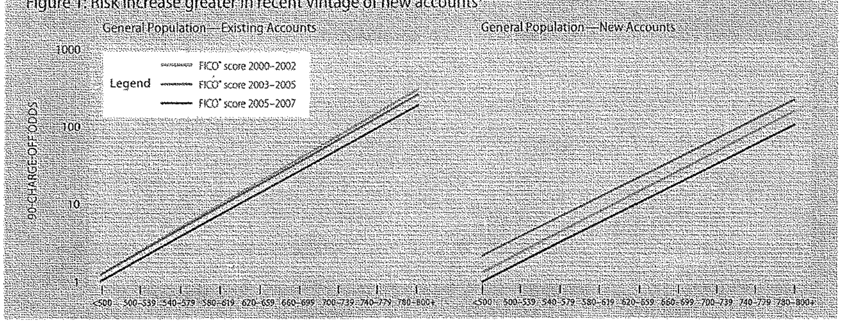
Let's explore these findings in more detail, including a focused look at risk trends for consumers with mortgage loans.

» Credit risk on the rise

To assess overall risk trends, FICO researchers analyzed FICO® score performance by comparing 2000–2002, 2003–2005 and 2005–2007 credit bureau data samples. The earliest period incorporates perform-ance impacts from 9-11 and the dot-com collapse; the middle period reflects the economic boom driven by the mortgage industry; and the most recent vintage reflects the early indication of increasing defaults and other fallout of the prior mortgage and refinance boom.

We used odds-to-score rankings to explore how relationships differed over the time periods. In other words, at a given score, were charge-off odds shifting higher, lower or staying the same?

Figure 1: Risk increase greater in recent vintage of new accounts[1]



Industry-wide, the 2005–2007 new accounts show greater risk compared to the previous vintages. The lower the line, the worse the odds, which translates into greater risk.

[1] *New accounts include consumers that opened new credit accounts in the six months following the 2000, 2003 and 2005 score dates. Existing accounts include those that opened accounts prior to the score dates.*

» INSIGHTS

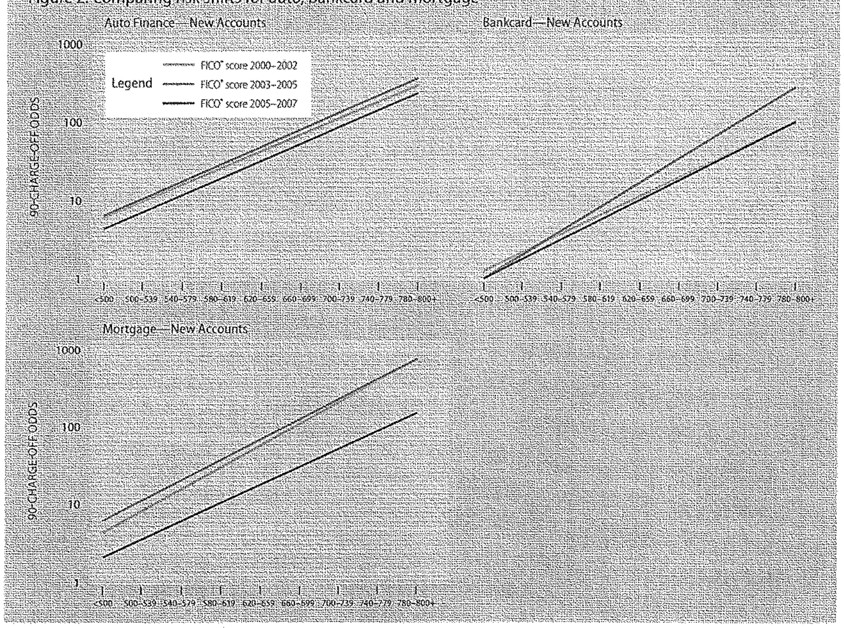
US credit risk has indeed risen industry-wide, as well as within bankcards, auto and mortgage.

Risk has increased in the most recent vintage for both existing and new account segments of the general population (see Figure 1 previous page). On average, the odds have shifted about 10 points lower for existing accounts in 2005–2007 compared to the previous samples. The movement is more noticeable on the new account segment, where odds have shifted about 30 points lower when compared to 2003–2005, and 15 points lower when compared to 2000–2002.

This trend holds true across industry verticals for the new account segment (Figure 2). Lender strategies and decisions enacted during the time of each vintage within each industry vertical would have had a large impact on the performance observed. The risk increase is greatest for new mortgage accounts, but is also observed for new bankcards and auto loans. Looking at the 2005–2007 data:

- **For new auto accounts,** the odds-to-score relationship has shifted about 30 points lower when compared to 2003–2005, and 15 points lower when compared to 2000–2002.

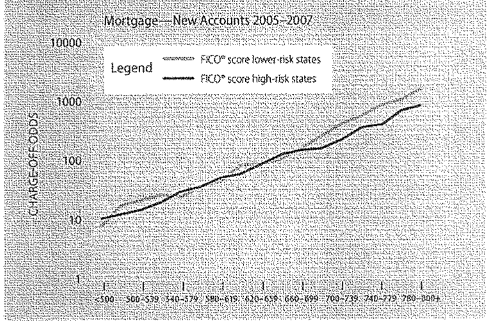
Figure 2: Comparing risk shifts for auto, bankcard and mortgage



New auto, bankcard and mortgage accounts in 2005–2007 show greater risk of charge-off compared to the previous vintages, with the greatest increases observed in new mortgages.

» INSIGHTS

Figure 3: Evaluating "high-risk" states
CA, NV, AZ, FL, OH, MI



In the 2005–2007 sample, consumers opening new mortgages that reside in higher-risk states show greater risk in the higher FICO® ranges compared to consumers opening mortgages in lower-risk states.

- **For new bankcard accounts,** the odds-to-score relationship has shifted about 20 points lower when compared to 2003–2005, and 5 points lower when compared to 2000–2002.
- **For new mortgage accounts**, the odds-to-score relationship has shifted about 80 points lower when compared to 2003–2005, and 70 points lower when compared to 2000–2002.

FICO evaluated performance of states that many in the industry would consider higher risk—Ohio and Michigan due to high unemployment, and California, Florida, Arizona and Nevada for mortgage fallout. Figure 3 shows the increases in risk for these higher-risk states compared to the rest of the nation.

Despite the overall risk increases, the analysis demonstrates that the FICO® score continues to effectively rank-order risk in the different time periods. The results also show that the odds at a given score range can shift over time, as lender practices evolve and economic conditions change. Lenders should frequently monitor and track this dynamic on their portfolios and adjust scoring strategies accordingly.

» Impact of mortgage risk across lending

Given the growing risk of new mortgage accounts, FICO decided to further evaluate FICO® score performance for consumers with mortgages. Has recent industry volatility changed general credit risk patterns?

Historically, consumers with multiple mortgages have been less risky than those with none or fewer mortgages. These consumers often have the assets and financial savvy necessary for property investment. And prior to the mortgage boom, lenders used more stringent underwriting criteria, especially for those purchasing non-owner-occupied properties.

But after an era of piggyback home loans and with property values falling below consumers' equity, some are walking away from their properties. Once a consumer's credit is tarnished by foreclosure, there is less incentive to maintain good credit ratings with other creditors.

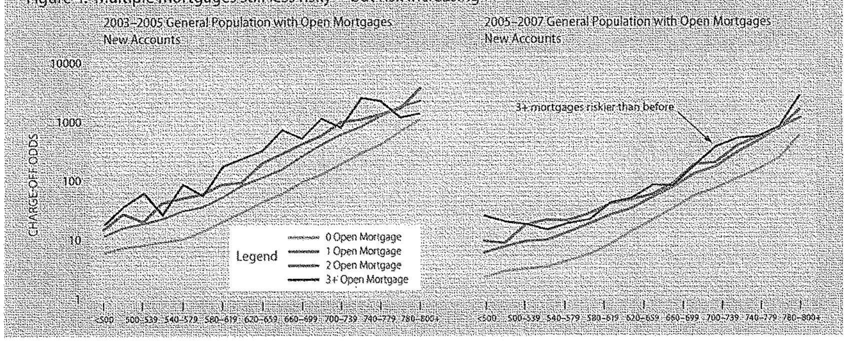
To better understand the impact of these trends, we evaluated whether risk patterns were changing for consumers with multiple mortgages across the 2003–2005 and 2005–2007 time periods.

Multiple mortgage holders are still less risky than those with none or fewer mortgages—but risk is increasing in the 2005–2007 data. This is particularly noticeable for new accounts (Figure 4 next page).

» INSIGHTS

In other words, while risk is increasing across all segments, we see greater increases for those with multiple mortgages. The 3+ mortgage consumers in 2005–2007 are performing at the same risk level as 3+ mortgage consumers in 2003–2005 that score 35–55 points lower. Similarly, odds-to-score relationships for consumers with two mortgages dropped by 45–50 points. By contrast, consumers with only one mortgage showed a 25–30 point difference.

Figure 4: Multiple mortgages still less risky—but risk increasing



In 2003–2005, consumers with 3+ mortgages are lower risk at a given score compared to those with fewer mortgages. In 2005–2007, the 3+ mortgage line drops and converges with those with fewer mortgages; thus, risk is increasing at a given score for this segment.

FICO conducted further analysis to better understand risk score predictors for new mortgage loans in the more recent timeframe. We found that the following segments pose greater risk than before:

- **Shorter time in file**—that is, consumers with newly established credit histories or with a recent build-up of newly opened credit.
- **Little to no prior installment experience**—suggesting a first-time big-ticket purchase, given the lack of auto and home loans on the credit file.
- **Multiple inquiries prior to mortgage opening**—suggesting aggressive credit-seeking behavior.[2]

Knowing these higher-risk credit bureau attributes can help lenders revise underwriting and customer management strategies, as we'll discuss in the "best practices" section of this paper.

» Best practices during uncertainty

Our research on risk trends, combined with today's economic climate, reinforce the need to evaluate and test existing credit policy risk controls.

- Lenders should closely track and **monitor portfolio performance by score**, and make adjustments accordingly.

[2] *Inquiries were processed through a de-duplication process, whereby mortgage-related inquiries within 45 days are considered as a single inquiry.*

- Given today's market, it's especially important to **evaluate portfolios by vintage and local economic factors.** If something looks unusual or a vintage isn't performing as expected, it is a red flag for lenders to tighten customer management in those risky areas—and to reevaluate targeting approaches and underwriting criteria.
- More **frequent score refreshes**, even among collateralized products, could identify losses earlier and signal a need to re-evaluate portfolio performance. We recommend at least quarterly account management updates.
- As mentioned earlier, our mortgage validation research identified **specific segments posing greater risk**—those with shorter time in file, multiple prior inquiries and less installment experience. As a result, lenders should review strategies to consider these changing risk patterns and tighten risk controls when appropriate.
- **Stronger risk tools** can also help. Validation results show that the latest release of the FICO® score, FICO® 08, increased predictive power in higher-risk segments, including credit shoppers and nonprime borrowers.

While credit bureau data and scores are highly predictive, good underwriting and customer management consider a broader view of risk. Risk factors not captured by bureau data, such as fraud or even product terms, can also impact portfolio performance.

To fill in this broader risk picture, lenders can benefit from the growing availability of non-traditional credit data (e.g., debit and phone utility data), as well as from geographic, economic and demographic data sources. Third-party data—and scores based on that data—can help identify changes to consumer risk that lenders might not otherwise be aware of. The FICO® Expansion® score leverages non-traditional credit data, and when used with the FICO® score, has been shown to boost risk assessment.

While lenders need to remain risk vigilant, the reality is that they also must be able to grow and pursue new opportunities—often even more difficult in times of uncertainty.

That's why we recommend using risk management tools and techniques that permit lenders to better calculate risk vs. reward—like champion/challenger testing to evaluate and refine strategies before rolling them out to a broad customer base. Lenders can evaluate which products and terms to offer, and which underwriting criteria, scores and external data are most useful in strategies, under varied market conditions for different consumer segments.

Stronger measures of consumer credit capacity can also help lenders identify new opportunities with less risk. FICO® Credit Capacity Index™ is a forward-looking analytic measure that, when combined with FICO® scores, determines, "For consumers who look equally risky, who can more safely manage additional credit?"

Balancing business growth and risk management, while tricky, certainly continues to be business-critical. Those that do it best are most likely to ride out the market fluctuations and challenges like those we face today.

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

Written Testimony of David H. Stevens
Assistant Secretary for Housing/FHA Commissioner
U.S. Department of Housing and Urban Development

"FHA Capital Reserve Ratio"

Hearing before the Subcommittee on Housing and Community Opportunity
U.S. House Committee on Financial Services
October 8, 2009

Chairwoman Waters, Ranking Member Capito, and Members of the Subcommittee, thank you for the opportunity to testify on the Federal Housing Administration's (FHA) Capital Reserve Ratio. As you know, the FHA is playing a critical role in the housing market and our economy right now – insuring a third of the home-purchase mortgage market and 80 percent of its purchase loans are for first-time homebuyers.

But as you also know, FHA recently announced that our independent, non-governmental actuarial review is expected to predict that FHA's capital reserve ratio will fall below two percent. There has been considerable confusion about what this announcement means for FHA's overall fiscal health and whether this means the taxpayer will bear any responsibility going forward.

And so I welcome this opportunity to clarify our situation and discuss the proactive steps being taken to ensure that FHA remains financially sound so that we can continue to support and revive the housing market.

FHA's Two Reserve Accounts and How They Function

Let me simply state at the outset that based on current projections, absent any catastrophic home price decline, FHA will not need to ask Congress and the American taxpayer for extraordinary assistance – we will not need a bailout. FHA holds reserves for the net present value of estimated net losses on its outstanding Mutual Mortgage Insurance Fund (MMI) loan guarantee portfolio in the financing account, and, backed by the full faith and credit of the federal government, will always have funds sufficient to meet projected costs. In combination with the Reserve Receipt Account, FHA's MMI Fund currently holds more than $30 billion in cash reserves.

The capital reserve account is a surplus reserve account that holds cash reserves in excess of the cash reserves held in the financing account, FHA's main reserve account. The financing account is required to hold reserves equal to the present value of net losses projected over the next thirty years. To the extent the reserves exceed the net present value cost of the loan guarantees, excess funds are paid to the capital reserve account. If the present value estimated net losses exceed the reserves, funds are paid from the reserve account to make up the difference. This is somewhat analogous to a checking and savings account, with the financing account holds reserves, pays default claims or other losses, and receives any payments received from the public, while the capital reserve account holds surplus cash.

So, why is the capital reserve ratio predicted to fall below two percent? That's because the capital reserve ratio only measures how much is in the secondary capital reserve account. In light of the severe decline in house prices, overall performance of the economy, and future housing price projections, FHA expects higher net losses than previously estimated on outstanding loan guarantees, over the next thirty years and more than are currently reserved for in the financing account. This change, in combination with stresses accounted for in prior reviews, will drive the ratio below two percent. As a result, surplus funds will be paid from the capital reserve account to the financing account. After this, there will still be additional funds remaining in the capital reserve account, over and above the reserve necessary to meet future expected losses.

While private mortgage insurers, lenders, Wall Street firms, and the GSEs participated in both owner-occupied and investor-owned markets; were exposed to exotic mortgages such as option-ARMs and interest-only loans; and some tolerated lax underwriting standards, FHA stuck to the basics during the housing boom: 30-year, fixed rate traditional loan products with standard underwriting requirements.

FHA only insures owner-occupied residences and has never insured exotic subprime, Alt-A, or "no-doc" mortgages. FHA has also never wavered from requiring full documentation of employment and income when underwriting new home purchases. This responsible approach has allowed us to limit losses during this economic crisis and fulfill our mission of providing safe opportunities for homeownership to those who can afford a home.

Bringing FHA into the 21st Century

Still, I am committed to ensuring the agency takes every step possible to provide a clearer direction for FHA to address the mortgage crisis, in support of President Obama and Secretary Donovan's policies and vision and to remain financially healthy for the long-term. I have already begun to improve portfolio analysis and management, tighten our risk controls, and overhaul our targeting and monitoring practices.

We have made more significant credit policy changes in the past few months than FHA has in decades.

We've brought on new leadership with broader and deeper knowledge and skills and a tighter set of risk controls for the agency, recently hiring a new Deputy Assistant Secretary for Single

Family Housing. And we are in the process of hiring a Chief Risk Officer to oversee a single division we want devoted solely to managing and mitigating risk to the insurance fund.

And with Congress's help, we are working to modernize our information technology systems, so that we can develop a set of commonly-used fraud detection tools and a fully-automated underwriting system that helps us focus our attention on the loan files that are most likely to contain serious deficiencies and I look forward to discussing more on each of these topics in detail later in the testimony.

FHA's Operations and Role in the Housing Market

The Federal Housing Administration provides mortgage insurance on loans made by FHA-approved private lenders. FHA does not lend directly to the consumer or issue debt to fund its operations. As such, FHA does not resemble private financial institutions, including mortgage lenders or investment banks like Countrywide Financial or Bear Stearns, to which FHA has been compared inaccurately by those who do not understand FHA's business model. FHA does not have a leverage ratio as it does not hold debt on its balance sheet. FHA is financed from mortgage insurance premiums paid to FHA in exchange for providing mortgage insurance. FHA holds reserves in its financing and capital reserve accounts. Balances in these accounts represent the net sum of premiums collected from borrowers minus any insurance claims that FHA pays to lenders, e.g., in the event that a homeowner defaults on their FHA-insured loan. FHA only insures those loans that meet FHA's underwriting criteria, as described earlier. By providing mortgage insurance to lenders on these loans, FHA provides protection to lenders against the risk of default, which expands liquidity in the market and has enabled homeownership opportunities to be expanded to a broader population.

Countercyclical Role of FHA and Private Mortgage Insurance

The private financial institutions to which FHA is most similar are private mortgage insurers (PMIs) who also offer mortgage insurance to private lenders to protect them from the risk of default by a borrower. FHA has recently experienced significant swings in its market share as FHA largely plays a countercyclical role to ensure critical liquidity remains in the mortgage market when private mortgage insurers decide to or are forced to insure fewer loans. Much attention has been paid to recent statistics showing that FHA is currently insuring more than 25% of new home mortgages, a significant increase from approximately 3% in 2006.[1] This increased market share is largely the result of market pullback by PMIs from providing new mortgage insurance as they are capital-constrained from paying claims and reserving funds for large expected losses on their historical portfolio. FHA is partially filling the void left by PMIs and is

[1] Inside Mortgage Finance

playing its historical role of enabling home purchases for individuals who can afford homeownership but do not have access to private mortgage insurance. FHA has not loosened its underwriting standards and in fact has experienced a significant improvement in credit quality of newly insured borrowers, from an average FICO score of 633 two years ago to 693 today.

Most lenders require mortgage insurance from homebuyers who obtain loans that are more than 80 percent of their new home's value, either in the form of FHA insurance or from PMIs. Unlike FHA, however, PMIs have been willing to offer a wider variety of insurance coverage options on a wider variety of mortgage products. At the peak of the housing boom, this flexibility led PMIs to offer insurance coverage on products such as subprime and option-ARM loans which enabled homebuyers to obtain mortgage insurance at a lower initial cost than a traditional fixed-rate FHA-insured loan. This led to a sharp decline in FHA's market share of home mortgages to approximately 3% in 2006 from its more traditional share of between 10-15% in the 1990s.[2] This dramatic reduction in market share also further limited FHA's exposure to problem loans as it saw its market share decline significantly in many states that have since experienced the sharpest price declines. Many of these problem loans insured by PMIs proved to be unsustainable to the borrower over the long-term and PMIs have since been subject to substantially higher default claims than FHA as borrowers can no longer afford these subprime and other types of exotic loans. For example, as of August 2009, FHA's seriously delinquent rate was 8.37 percent. The overall seriously delinquent rate for Alt-A mortgages is 21 percent as of July 2009 and the seriously delinquent rate for negative amortization Alt-A mortgages is 33 percent.

A report released by the Federal Reserve last Wednesday, October 1, 2009 states:

> Beginning in the early part of 2008, PMI companies started limiting their issuance of PMI insurance and raising prices because of rising claims and binding capital restrictions in certain states. As a consequence, Fannie Mae and Freddie Mac substantially reduced their purchases of loans with loan-to-value ratios (LTV) above 80 percent, which by statute require PMI (or other credit enhancement). Both GSEs [Fannie Mae and Freddie Mac] also raised their credit guarantee fees for such loans at this time as well.[3]

These actions taken by PMIs and GSEs in reaction to losses on their historical portfolios have led to FHA-insured loans becoming relatively cheaper and more accessible to borrowers, compared

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[2] FHA Share of Home Purchase Activity; Sources: FHA Office of Evaluation, National Association of Realtors, U.S. Census Bureau

[3] "The 2008 HMDA Data: The Mortgage Market during a Turbulent Year," draft report published October 1, 2009 in the *Federal Reserve Bulletin*

to PMI-insured loans than they were during the boom. FHA's increased market share is a result of this countercyclical market dynamic and not in itself a reflection of the riskiness or lack thereof of newly insured loans.

Historically, FHA has played this countercyclical role more than once before. FHA was created in 1934 to fill a market void in which few individuals had access to homeownership due to typical mortgage loan terms requiring 50% downpayment and three to five year repayment schedules. FHA insurance enabled lenders to offer more affordable loan terms that led America to transition from a nation primarily of renters to one of the highest homeownership rates in the world. In the 1980s, FHA moved in to steady 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. FHA's role has evolved over the past 75 years to continue to serve as a countercyclical stabilizing force in the market and also to ensure that underserved populations have access to homeownership opportunities.

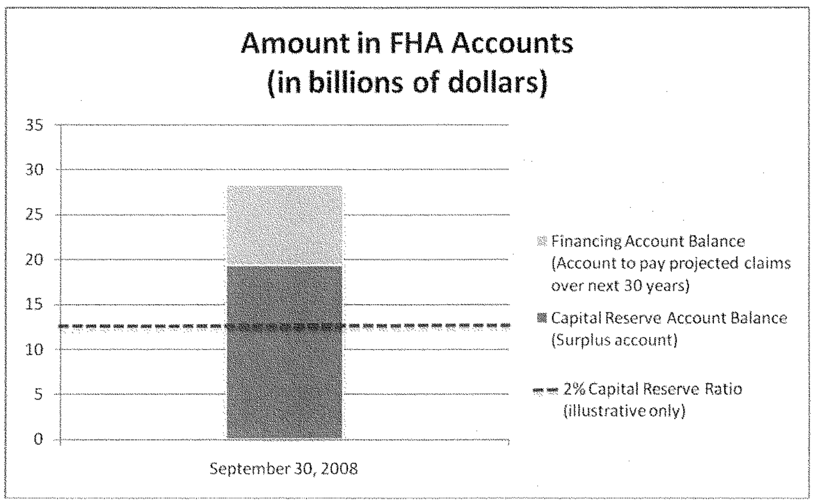
In fiscal year 2008, FHA insured over 1.1 million single-family loans – almost triple what was insured the year before. In fiscal year 2009, FHA insured approximately 2 million loans. FHA anticipates that it will continue to insure a significant volume of mortgages in fiscal year 2010 as it continues to play an important role in the housing market.

Today, FHA is critical to the recovery of the housing market for both existing and new homeowners. FHA's single-family purchase-loan portfolio is currently 80 percent first-time homebuyers, of which 27 percent are minorities. FHA provides opportunities for first-time homebuyers who have good credit histories but may not have a large downpayment to purchase homes, which has a stabilizing effect on home values. Equally as important, over 49 percent of the loans insured by FHA in fiscal year 2009 have been refinances, thereby helping existing homeowners to move into safe, fixed-rate loans, with historically low interest rates. These refinances have, on average, saved homeowners between $100 - $200 per month on their housing expenses.

Additional Information about the Capital Reserve Ratio

New upfront mortgage insurance premiums paid at loan closing and ongoing premiums paid over the life of the loan are deposited in the financing account. Based on an annual review of economic conditions and projections, the cost of outstanding loan guarantees are reevaluated, and the amount of reserves held in the financing account are adjusted to ensure that there are sufficient resources in the financing account to cover the net present value of estimated costs of outstanding guarantees, and any surplus reserves are held in the capital reserve account. At the end of fiscal year 2008, the independent audit led to the financing account holding $9 billion in reserves and obligated balances, and the capital reserve account held $19.3 billion in excess reserves, for a total combined reserve balance of $28.3 billion. The capital reserve ratio only refers to the funds held in the capital reserve account. As such, the fiscal year 2008 capital ratio was 3% on a total insurance in force of $439.6 billion. This is illustrated below in Figure 1.

Figure 1. Fiscal Year 2008 Combined FHA Reserve Accounts



FHA is currently awaiting the final results of its independent actuarial review for Fiscal Year 2009. Preliminary results have indicated that additional funds will need to be transferred from the capital reserve account to the financing account. This transfer is necessitated by an increase in projected future losses on outstanding loan guarantees. This requires FHA to hold more funds in its financing account to cover expected future losses. The primary reason for this increase in dedicated loss reserves is a new home price forecast produced by IHS Global Insight, which is one component used by the actuarial firm to project future losses, which shows the bottom of the market delayed from 2009 to 2010, and reflects an additional 8.4 percent price decline in the US Single Family housing market. It is important to note that in their September forecast, Global Insight has moderated their forecast to a 7.7 percent decline before prices stabilize, and they, as well as other market data sources have indicated that prices may have already stabilized in many parts of the country. The change in housing price forecasts between 2008 and 2009 is depicted in Figure 2 below.

Figure 2. IHS Global Insight August 2009 Revised Housing Price Index Forecast

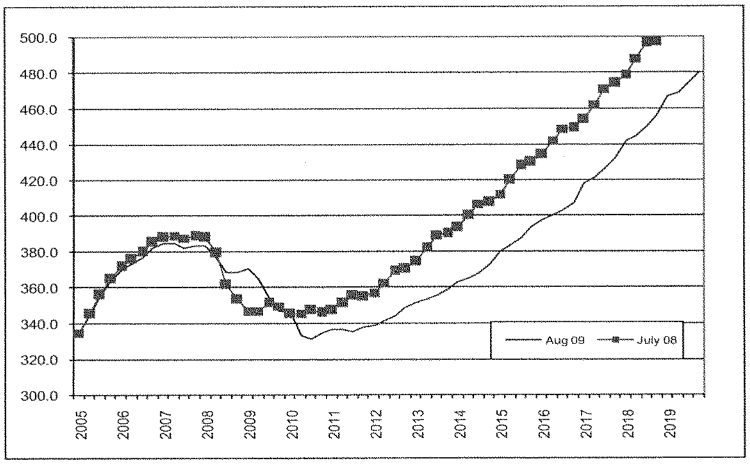
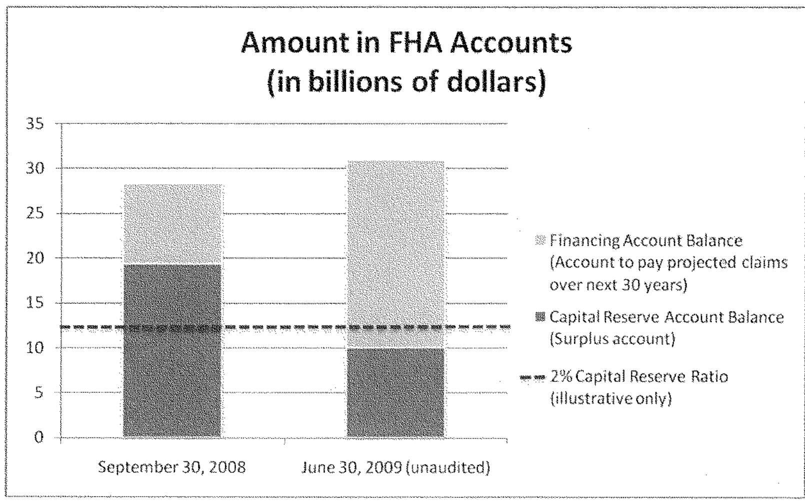


Figure 3 portrays the flow of funds from the capital reserve to the financing account and is an illustration of how FHA adjusts its funds to reflect projections of expected future losses. The most recent period for which FHA has financial results is June 30, 2009 (unaudited). The total reserve balance has increased because of a surplus in total premium revenue over net insurance claim expenses over the nine month period. The shifting of funds from the capital reserve account to the financing account was done as a result of the FY 2008 actuarial review, which indicated that additional funds should be transferred to the financing account to cover future expected losses.

Figure 3. Change in Combined FHA Reserve Accounts as of June 30, 3009



The new FY 2009 actuarial review is expected to indicate that FHA will again need to increase its loan loss reserves in the financing account because of house price assumptions and other economic variables that suggest an increase in cost on the outstanding portfolio. This will necessitate an additional transfer of funds from the capital reserve account to the financing account. Based on the preliminary results, the capital reserve ratio is expected to drop below the two percent threshold. The reestimated cost of the portfolio (and actual amount of the capital reserve that will be paid to the financing account) will be reevaluated, and reflected in the 2011 Budget. If the portfolio ultimately performs better than current forecasts suggest, there will be a downward reestimate, and the excess funds returned to the capital reserve. Over the life of the outstanding loan guarantees, it is very likely that the projections will be revised – in either direction. Should future projections indicate that FHA will experience fewer losses in the future, funds may be shifted from back into the capital reserve account. The drop in the capital reserve ratio below two percent is anticipated to be for a relatively short period of time and the ratio is expected to return above two percent within the next two to three years, on its own, even if FHA were to make no policy changes at all. The current drop in the capital ratio in no way indicates that FHA is at risk of needing an immediate capital infusion as it currently holds more than $30 billion in total reserves. To the extent that FHA's newly insured MMI loans are expected to earn revenues in excess of expected losses on a present value basis further strengthens its capital position as new mortgage insurance premiums will continue to add to FHA's reserves. While

FHA's capital reserve ratio has dropped below two percent, this is again a limited measure, and does not necessary indiciate FHA's overall financial health.

Newly Insured Loans and Future Books of Business

- The drop in the capital reserve ratio reflects FHA's current position after experiencing the depths of the recession and a historic decline in housing values. As newly insured loans are being underwritten at or close to the bottom of housing prices, there is potentially lower risk that housing values of these new loans will become underwater in the future.
- Recent dynamics in the purchase market have improved the financial health of FHA. Due to the pullback by PMIs, the average credit quality of FHA borrowers had improved significantly in the last two years. The average FICO score for all existing FHA borrowers is 693, compared to 633 two years ago. Two years ago, nearly half of all FHA purchase borrowers had a FICO less than 620; today that number is only 7.5 percent.

FHA is Taking Proactive Measures to Ensure its Fiscal Health

FHA is taking proactive steps with newly-introduced and future credit policy changes, and looking to current and future books of business as a means to increase the capital reserve account and restore the resulting capital reserve ratio back over two percent as soon as possible.

FHA has extensively upgraded its focus on and capabilities for prudent risk management. On September 18, 2009, FHA announced that it will be appointing a Chief Risk Officer, for the first time in FHA's history. FHA's current risk management functions are dispersed across a number of divisions. The Chief Risk Officer will oversee the coordination of FHA's risk management efforts in a single division devoted solely to managing and mitigating risk to FHA's insurance fund – across all of its programs.

Additionally, FHA has recently appointed a new Deputy Assistant Secretary for Single Family Housing. Vicki Bott joined FHA on October 5, 2009 to take on this role and brings over 20 years of experience in the mortgage industry including senior positions at Wells Fargo and other large institutional lenders. Ms. Bott provides additional leadership focused on ensuring the fiscal health of FHA and devoted to enabling FHA to continue providing a critical role in the recovery of the housing market and broader economy.

Finally, FHA announced a series of credit policy changes on September 18, 2009 that are a first step to strengthen FHA's risk management and to ensure responsible lending. These changes are listed below and are described in detail in the attached appendix.

Credit Policy Changes

Changes Effective January 1, 2010 via Mortgagee Letter

- Require Submission of Audited Financial Statements by Supervised Mortgagees.
- Modify Procedures for Streamline Refinance Transactions
- Require Appraiser Independence In Loan Originations
- Modify Appraisal Validity Period
- Appraisal Portability

Changes Being Pursued by Rule Making Process and Currently Under Notice and Comment

- Modify Mortgagee Approval and Participation in FHA Loan Origination
- Increase Net-Worth Requirements for Mortgagees

Conclusion

And so, even as FHA is once again playing a critical countercyclical role in our economy—as it did during the Great Depression and during the Oil Patch crisis of the 1980's, stepping up to ensure housing markets function where the private sector cannot on its own—we are taking nothing for granted.

FHA is working aggressively to not only make sure that our reserves reach congressionally-mandated levels over projected future losses – to make sure we keep affordable, responsible loans flowing, our housing market viable, and our economy on the road to recovery.

Once again, I would like to thank you for the opportunity to participate in today's hearing and for your continued leadership. With that, I am happy to answer any questions you may have.

Appendix – Description of Recent FHA Credit Policy Changes

Changes Effective January 1, 2010 via Mortgagee Letter

- Require Submission of Audited Financial Statements by Supervised Mortgagees.
Supervised mortgagees will be required to submit audited annual financial statements to FHA. This new requirement is a prudent safeguard that permits FHA to make sure that those entities with which it does business are adequately capitalized to meet potential needs. FHA is aware that the majority of supervised and non-supervised mortgagees are already required to prepare audited financial statements for various regulatory bodies, Government Sponsored Enterprises (GSEs), and investors. Given these existing requirements, FHA's new policy will help to reduce risk at limited new costs for approved mortgagees.

- Modify Procedures for Streamline Refinance Transactions
Current procedures are revised for streamline refinance transactions to establish new requirements for seasoning, payment history, income verification, and demonstration of net tangible benefit to the borrower; provide for collection of credit score information when available; and to cap maximum CLTV at 125 percent. An appraisal will be required in all cases where a borrower wants to add closing costs to the transaction. These revisions bring documentation standards for streamline refinance transactions in line with other FHA loan origination guidelines, make sure that the borrower is capable of repaying the new mortgage, and prohibit the dangerous practice of loan churning, where borrowers raise cash through successive cash-out refinancings that put them further in debt.

- Require Appraiser Independence In Loan Originations
New guidelines provided on ordering appraisals for FHA-insured mortgages and reaffirms existing policy on FHA requirements regarding appraiser independence and geographic competence. Mortgage brokers and commission based lender staff are prohibited from ordering appraisals. FHA does not require the use of Appraisal Management Companies or other third party providers, but does require that lenders take responsibility to assure appraiser independence. While FHA's existing policies regarding appraiser independence are consistent with the Home Valuation Code of Conduct (HVCC), FHA will adopt language from the Code to ensure full alignment of FHA and GSE standards.

- Modify Appraisal Validity Period
FHA's appraisal validity period will be reduced to four months for all properties including existing, proposed and new construction. Previous validity periods were six months for existing properties and up to twelve months for proposed and under construction properties. This provides for more accurate home values used for underwriting FHA-insured mortgages during volatile housing market conditions.

- Appraisal Portability
  New guidelines that allow a second appraisal to be ordered under a limited set of circumstances when a borrower switches from one lender to another and restates the requirement that the first lender must transfer the appraisal to the second lender at the request of the borrower. This will prevent delays in closing that often occur when a loan is transferred to a new lender.

Changes Being Pursued by Rule Making Process and Currently Under Notice and Comment

- Modify Mortgagee Approval and Participation in FHA Loan Origination
  Lenders seeking approval to originate, underwrite, or service an FHA loan must meet the eligibility criteria for a supervised or non-supervised mortgagee. Mortgagees with this approval status must assume liability for all the loans they originate and/or underwrite. Loan Correspondents (mortgage brokers) will continue to be able to originate FHA-insured loans through their relationships with approved mortgagees; however they will no longer receive independent FHA approval for origination eligibility. These policy changes will require the FHA approved mortgagee to assume responsibility and liability for the FHA insured loan underwritten and closed by the approved mortgagee. These changes align FHA with the GSEs and will potentially increase the number of loan correspondents (mortgage brokers) who are eligible to originate FHA-insured loans while providing for more effective oversight of loan correspondents through the FHA approved mortgagees.

- Increase Net-Worth Requirements for Mortgagees
  FHA plans to propose to increase the net worth requirement for approved mortgagees to meet industry standards. The requirement is currently at $250,000 and has not been increased since 1993. HUD is proposing an initial increase of approximately $1,000,000 that would be in place within one year of the enactment of this rule. To maintain consistency with industry standards, HUD may propose that the net worth requirements be increased further in future years to a level comparable to those required by GSEs and other market institutions. These changes will help to ensure that FHA lenders are sufficiently capitalized to meet potential needs, thereby permitting HUD to mitigate losses and decrease risks to the FHA insurance fund.

Questions for Peter Bell, President
National Reverse Mortgage Lenders Association

Subcommittee on Housing and Community Opportunity
Hearing entitled "The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers"

October 8, 2009

Question: It is currently difficult to detect fraud in the Home Equity Conversion Mortgage program because lenders do not need to report reverse mortgage transactions under the Home Mortgage Disclosure Act when the borrower owns the home free and clear before the transaction. Does your organization support increasing reporting requirements under the Home Mortgage Disclosure Act?

Answer: The information stated in the question is incorrect and misinformed. Reverse mortgages are not exempt from HMDA reporting "when the borrower owns the home free and clear before the transaction." Reverse mortgages that are "closed-end loans" are required to be reported under HMDA. Those that are "open-end" loans are not required to be reported under HMDA. This is the same rule as for all other mortgage loans, forward as well as reverse.

"Open-end" loans are called that because funds that have been drawn down and subsequently paid back are available to be drawn down again. This is a common feature on home equity lines of credit, as well as on variable rate HECMs. HMDA does not require lenders to report "open-end" loans.

Fixed-rate HECMs are typically offered as "closed-end" loans. The full amount of funds available to the borrower must be drawn down upon closing and, if paid back before loan maturity, cannot be drawn down again. Such "closed-end" reverse mortgages are already subject to reporting requirements under HMDA.

Furthermore, we don't understand what information the questioner feels could be obtained from HMDA reporting that would help detect fraud in reverse mortgage transactions. HMDA reporting is required to track lending practices from a fair housing and anti-redlining perspective. The data that is collected would not help detect fraud.

Question: What is included in the typical training program for a reverse mortgage broker?

Answer: All companies that originate loans under the HECM program must be approved by FHA as either "correspondents" or "lenders." FHA has specific lender approval requirements for each of these categories. Furthermore, when starting to originate HECMs, a company must process their first several loans as "test cases" with the HUD Home Ownership Center that has jurisdiction over the area where the company is headquartered.

There are approximately 2,000 companies that have originated HECM over the past year or two.

These include mortgage brokers, mortgage bankers, credit unions and banks. Each has its own training systems and procedures. In some cases, banks or other lenders maintain their own in-house training programs. In other cases, companies might utilize third-party training programs or courses offered by providers such as the Mortgage Bankers Association (MBA) or our organization, National Reverse Mortgage Lenders Association (NRMLA). A loan that is originated by any of the approximately 2,000 FHA-approved correspondents or lenders ultimately is placed with one of the dozen or so "seller-servicers" that deliver the loans to Fannie Mae or package them into Ginnie Mae securities. Typically, the seller-servicers, often referred to in the trade as "wholesalers" provide additional training, education and technical support to their correspondents.

Training typically covers details and features of the HECM product, the mechanics of how the program works, HECM rules and requirements, who the loans are appropriate for, how counseling works and other HECM related topics. Courses offered by NRMLA routinely cover related topics, as well, including how to spot elder financial abuse and what to do about it, recognizing cognitive impairment, how to use a reverse mortgage to prevent a foreclosure, acceptable advertising, and ethical issues in the reverse mortgage business.

Question: Many reverse mortgage companies advertise on their websites that they have employees that are "certified senior advisors" or "certified reverse mortgage consultants." What training must these brokers have? Do these brokers have a fiduciary duty to borrowers?

Answer: We are not aware of "many reverse mortgage companies" advertising on their websites in the manner described above. Perhaps the questioner is confused here by title used by some companies where loan originators are referred to as "reverse mortgage advisors" or "reverse mortgage consultants."

The "Certified Senior Advisor" (CSA) is a professional designation offered by the Society of Certified Senior Advisors. This designation is pursued by professionals from a number of different disciplines who provide services to a senior clientele. Candidates for the CSA designation pursue a prescribed course of study, must pass an exam and take continuing education to maintain the designation.

The mission of the Society of Certified Senior Advisors, according to their website, is as follows:

> SCSA educates professionals to work more effectively with their senior clients. We believe that the right kind of planning, recommendations and referrals can make aging a state to be savored instead of a fate to be feared. For those who work with seniors, that means understanding the key health, social and financial factors that are important to seniors—and how these factors work together. CSAs are able to integrate this into their professional practices, no matter what field they're in. They've learned how incredibly gratifying it is to help seniors achieve their goals, and the seniors they've worked with have learned how important it is to work with someone who truly understands their age-related circumstances.

We are not aware of any official "certified reverse mortgage consultant designation." A company that provides third-party training to reverse mortgage professionals had embarked upon a program to offer such a credential in the past, but has since dropped the effort. Instead, that consulting company has decided to recommend that reverse mortgage professionals pursue the Certified Reverse Mortgage Professional (CRMP) designation that is currently being developed by our organization, NRMLA.
NRMLA has been working on developing this credentialing program for the past two and a half years, working with a psychometric consultant and testing organization, Professional Testing, Inc., to develop a professional designation program in accordance with the ANSI standards for such programs. (Psychometrics is the science of measuring knowledge.) To earn the CRMP designation a candidate will have to meet certain background and experiential requirements, complete sixteen hours of professional education in courses approved by NRMLA, participate in a NRMLA-hosted ethics forum, be properly licensed in any states in which they work, undergo a background check and pass a rigorous exam. The NRMLA Certified Reverse Mortgage Professional designation will be conferred upon the first group of candidates in the months ahead.

As of January 1, 2010, loan officers will have to be licensed in all states under the federal SAFE Act, unless they are employed by a federally-regulated depository institution that is exempt from licensing under the Act. In addition to any training provided within reverse mortgage companies, each state has its own educational requirements for licensees under the new law.

At the present time, mortgage brokers do not have a fiduciary duty to borrowers. However, they are subject to standards and requirements under state laws and processes are in place for enforcement.

Question: How does NRMLA monitor the marketing of reverse mortgage products in order to ensure that potential customers do not misunderstand reverse mortgage products or confuse reverse mortgage products with government-provided benefits?

Answer: First of all, NRMLA member companies and all of their employees are required to abide by our Code of Ethics & Professional Responsibility (copy attached). The Code is further amplified by best practices and ethics advisory memoranda. Both the Code and an ethics advisory memorandum govern NRMLA's position on advertising and consumer communications.

Violations of the NRMLA Code are reported by consumers, counselors, regulators and other lenders and are acted upon by our Ethics Committee. Sanctions available to the Ethics committee include probation, suspension or termination of membership, reporting to regulatory authorities and public naming of offendors. All of these sanctions have been taken in various circumstances, with a first case to result in public naming currently undergoing final review by our counsel and an appeals committee.

Advertising in a manner that might confuse a prospective borrower into thinking an advertisement or offer for a reverse mortgage is an official communication from a government agency or an offer of a governmental benefit is a violation of our standards and we have a process in place to deal with such transgressions.

Question: Do you believe yield spread premiums should be prohibited on reverse mortgages?

Answer: It is difficult to answer this question without knowing exactly what questioner means by it. There are many different interpretations of what is meant by the term "yield spread premiums"

If the question is whether or not NRMLA believes it might be appropriate to place price controls on interest rates for reverse mortgages, the answer would clearly be no. The cost of capital fluctuates in response to market conditions and reverse mortgage lenders must be able to meet the yield demands of investors or no capital would be available to fund reverse mortgages.

NRMLA does believe that all lenders should adhere to fair and ethical pricing policies. If certain borrowers are to be charged differently than others there must be some justification for any variation. For example, a borrower being quoted a higher interest rate margin should receive some discernible benefit as a result. This could be a reduced origination fee, the lender paying for fees, services or other benefits that would typically be paid by the borrower, etc. At the same time, it should be noted that not all loans are comparable. There are regional differences in the costs of doing business, some cases require much more time and effort, particularly if a loan officer must travel a long distance in order to serve a customer's needs, some borrowers require more intensive assistance.

It should also be noted, for the record, that there already exists a statutory cap on the origination fee that a borrower can be charged. The maximum origination fee for any HECM loan is 2% of the first $200,000 of maximum claim amount + 1% of the balance of maximum claim limit over $200,000, with an overall maximum origination fee of $6,000. In other words, all HECMs with maximum claim amounts over $400,000 are limited to an origination fee cap of $6,000. Finally, it should be noted that FHA places administrative restrictions on the servicing fees that can be charged on a HECM reverse mortgage.

What is the typical downpayment amount contributed by a private mortgage insurance borrower?

Mortgage insurers will insure loans with various downpayments depending on the borrower's financial capability. In today's housing environment, where house prices are continuing to decline in many markets, borrowers generally put down at least five percent.

How have private mortgage insurance premiums historically differed from FHA premiums? How have average private mortgage insurance premiums changed in the last year?

First, FHA's premiums are set by statute. Individual mortgage insurers set their own rates based on an extensive actuarial analysis and they are then submitted to state insurance regulators for approval.

Second, the FHA premium consists of a large upfront premium paid at closing and then a smaller annual premium. The FHA upfront premium is generally financed into the mortgage. While private mortgage insurers offer that premium payment structure as well, they also offer a structure that does not require the borrower to make an up front payment, and instead requires only monthly payments. Over 90% of borrowers who use mortgage insurance pay in small, monthly payments. Furthermore, in accordance with federal law, those premiums are discontinued when the loan either amortizes to 78% of the property value at the time the loan was made or earlier if the loan outstanding amount equals 80% or less of the current value.

Third, individual mortgage insurers also consider the amount of the downpayment in setting their premiums -- the smaller the downpayment, the higher the premium. The National Affordable Housing Act of 1990 granted FHA the ability to charge borrowers a higher premium when they put less down but FHA did not fully exercise that right until last year.

Finally, unlike FHA, private mortgage insurers do not insure 100% of the loan amount. Instead, mortgage insurers generally insure 20% to 35% of the loan amount. This model ensures that lenders share a portion of the risk, and that private sector capital is available to address default and foreclosure related losses. Premiums for insurance covering 20% of the loan amount generally are lower than when the coverage is 35%, for otherwise comparable loans.

Mortgage insurers set their premiums individually and, while the state regulators make that information public, there is no existing study that compares these rates. In the last year, mortgage insurers have generally increased their premiums in response to the volatility, particularly given rising unemployment and declining home prices.

How do borrowers premiums typically differ by downpayment size?

As noted above, mortgage insurers set their premiums individually. Generally, mortgage insurers charge higher premiums for loans with lower downpayments given the higher risk. FHA also began this practice last year when it exercised the full power Congress gave it in 1990 to charge higher annual premiums to borrowers who put less down.

Has Radian Guaranty Inc. or other private mortgage insurance companies stopped the issuance of mortgage insurance in certain states, counties or cities in recent months?

No, Radian has not stopped the issuance of mortgage insurance in certain states, counties or cities. At the beginning of the severe housing downturn, Radian, like other mortgage insurers, required borrowers to put more down or had different underwriting guidelines in markets where house prices were falling dramatically. We have returned to using similar underwriting guidelines and downpayment requirements in all markets. We believe other mortgage insurers have started to do the same.

In your testimony, you note that private mortgage insurers are playing a leadership role in working with borrowers and lenders to ensure success of the Making Home Affordable program. Please elaborate on private mortgage insurance companies' involvement in this program.

The members of the Mortgage Insurance Companies of America (MICA) have been deeply committed to ensuring the success of the Making Home Affordable program since its inception. As a group, we have led borrower outreach efforts by working with consumer counseling agencies, partnering with Hope Now, utilizing specialized vendors and, of course, using our internal resources. All of these efforts have been directed at giving every borrower the best opportunity to remain in their home. We also have devoted resources to educating the public and the servicer community about the programs that are available to assist borrowers and servicers as they struggle through these unprecedented times. These efforts have resulted in a significant number of instructor-led classes, web resources, and other training materials that are provided free of charge. Equally important, each company has offered its support to the servicer community, the GSEs, and the Treasury Department to help address the complex and difficult challenges we face in stabilizing the single family mortgage market. Whether through on-site representatives that process transactions and offer other assistance, financial support to defray some of the cost of doing high quality work, or supplementing the workforce through our vendor networks, MICA's members are working hard to make these foreclosure prevention programs a success.

Responses for the Record from the

National Association of REALTORS®

Re a hearing of the Financial Services
Subcommittee on Housing and Community Opportunity
Hearing entitled "The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers"
On October 8, 2009

- **What difficulties do NAR members cite with regard to homebuyers being able to utilize the first-time homebuyer tax credit?**

  The primary drawback we have heard from our members about utilizing the tax credit, is that existing homeowners have not been able to use it. Limiting the tax credit to first time homebuyers limits the ability of the tax credit to facilitate the housing recovery. While the current first-time homebuyer credit has generated substantial activity in the entry- level category of homes, inventories of "move-up" homes have remained high. Expanding the credit to purchasers who have a proven track record of homeownership should even out the current inventory. Likewise, expanding the income limits would also make the credit more effective.

- **What challenges do borrowers face with regard to monetization of the homebuyer tax credit?**

  Currently, only 17 state housing finance agencies (HFAs) offer a product buyers can use that will effectively monetize the tax credit for down payment purposes. And even in those states, funding is extremely limited. Allowing homebuyers to monetize the credit would allow buyers to use the credits to help cover closing costs and downpayments.

- **NAR recommends that the owner-occupancy requirement for FHA condominium mortgages be eliminated. If this change were adopted, could it potentially increase speculative purchase of condominium units while not reducing vacancy rates?**

  Currently, FHA has a 50 percent owner/occupancy requirement for condominium purchases. NAR recommends that FHA eliminate the occupancy ratio for FHA mortgages for all condominium developments. While we applaud FHA for reducing the occupancy ratio to 50 percent, from 51 percent, eliminating this requirement will allow more owner/occupants to purchase units in condominiums, increase the percentage of units in a given project occupied by a resident owner, and thus help stabilize these developments and the community. Fannie Mae and Freddie Mac, the government sponsored enterprises (GSEs), do not have an occupancy ratio for condominium projects if the borrower is going to occupy the unit after purchase.

  FHA does not allow investors to use FHA mortgages- only homeowners. So changing this requirement would not have any impact on investor purchases of condominium units. Rather, eliminating this requirement will assist many homeowners in the purchase of an affordable home, and will help with existing condominium developments, who are now experiencing high vacancy rates, or owners who are being forced to rent, because condominium homebuyers do not have access to affordable, safe financing through FHA.

NAR also recommends amending the FHA occupancy rules so bank-owned REO properties are no longer counted for the purpose of calculating occupancy ratios. Reducing the owner-occupancy ratio and not including bank-owned REO properties in the calculation will help condominium developments with significant percentages of REO properties. This change in policy will align with the policies of Fannie Mae and Freddie Mac. It will attract buyers seeking FHA mortgages to condominium developments with available units for purchase while creating a level of continuity across the industry.

- **Does NAR anticipate that the Administration's proposed incentives to increase the use of short sales by lenders will be effective?**

  NAR believes that the outline of the program, announced on May 14, 2009, but still not implemented, holds great potential for success. The key will be whether the servicers, lenders, second lien holders, and investors recognize the value of short sales over foreclosures. In most cases, the loss from a short sale is significantly less than the loss from a foreclosure. NAR knows from participation in roundtables with all affected parties that there are serious reservations about whether the incentives for second lien holders are sufficient and also whether the program will be consistent with the pooling and servicing agreements between investors and servicers. In other words, NAR is extremely hopeful that the program will succeed but worried about potential pitfalls.

Credit scores are not required criteria for FHA loan origination. However, there have been recent reports that, over the last year, lenders have imposed credit score requirements for borrowers. To what extent are your members engaged in this practice?

Many lenders have begun to impose minimum credit score requirements for FHA borrowers. The events of the last two years have led lenders to "go back to basics," as financial firms strive to ensure they are making sound and responsible underwriting decisions. Such practices protect borrowers and also help lenders manage their financial risk. It is important to note that lenders still have the flexibility to make exceptions based on an individual borrower's characteristics, such as increased reserves and low debt-to-income ratio.

How much money would the typical Home Equity Conversion Mortgage borrower need to produce upfront in order to qualify for a reverse mortgage under your recommendation for a mandatory three-year escrowing of all taxes and insurance?

The popularity of Home Equity Conversion Mortgages (HECMs) has risen dramatically with the growth of the senior population, the lagging economy, and the temporary increase in the HECM loan limit. MBA believes that a reverse mortgage is a valuable financial tool and a practical way of allowing seniors to age in the comfort of their own homes. MBA also appreciates the need to maintain strong consumer protections for reverse mortgages. Consumers, public officials, and members of the mortgage industry are all understandably concerned that unscrupulous lenders could take advantage of vulnerable seniors by providing misinformation or engaging in unethical cross-selling practices.

MBA has been proactive in addressing these concerns and created the Executive Task Force on Reverse Lending, which includes decision-makers at large and small companies that originate reverse mortgages. The first outcome of this group was the development of the MBA model state bill, which would allow lenders to conduct their businesses responsibly and protect consumers. One of the issues the bill addresses is that a small (approximately 2 percent) but growing percentage of seniors with reverse mortgages are not paying their taxes and insurance, as required by the terms of the program. This is a problem because unpaid taxes add to the debt of the senior, while not having hazard insurance is a financial risk to the borrower. Traditionally, lenders have absorbed these costs, instead of foreclosing on a loan, but as these problems grow, lenders will not be able to continue this practice. MBA recommended a three-year escrow of taxes and insurance as a way to address this issue. This would ensure that if a senior experienced economic trouble during the life of the mortgage, the senior would be able to cover this expense for a minimum of three years.

MBA, however, does not think this option is the only way to protect both the lender and senior against unpaid taxes and insurance and we will be making additional recommendations in the future.

How did MBA arrive at their recommendation that participating FHA mortgagees should have a minimum net worth of $500,000, or 1 percent of FHA loan volume up to $1.5 million (whichever is greater)? Commissioner Stevens has proposed a minimum net worth requirement that is double MBA's minimum qualifying amount.

How many current participating FHA mortgagees would be eliminated under your recommended net worth requirements? How does that estimate differ from Commissioner Stevens' proposal?

MBA has supported and continues to support rigorous standards for mortgage bankers as a means of assuring appropriate barriers to entry and protection of the public. Net worth requirements are an appropriate way to protect borrowers from doing business with undercapitalized lenders. MBA's current policy supports a minimum corporate net worth requirement for mortgage bankers of $500,000 or one percent of FHA loan volume, up to a maximum of $1.5 million, as evidenced by audited financial statements. We also support mortgage bankers maintaining a bond sufficient to provide reasonable protection to consumers and others. New requirements for mortgage bankers should be uniform across all states in an effort to protect consumers and lower costs through maximum competition.

Because MBA only collects net worth data on a relatively small subset of the mortgage industry (independent mortgage bankers and subsidiaries), it is difficult to provide a specific number of how many current participating FHA mortgagees would be eliminated if the minimum net worth was raised from $500,000 to $1 million. We are concerned, however, that reputable, small, independent mortgage bankers, who have been serving their communities responsibly for years, would not meet such a dramatically-increased threshold. This would then result in underserved communities losing access to competitive lending options.

One issue that is often overlooked in this debate is that if net worth requirements are raised too high, this would discourage new entrants from coming into the market. Small mortgage bankers are critical to serving the lending needs of the non-metropolitan areas of the country. MBA is mindful that we should not stifle the growth of such new business development, especially in today's economy.

Questions to Mr. Edward Pinto

Re a hearing of the Financial Services

Subcommittee on Housing and Community Opportunity

Hearing entitled "The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers"

On October 8, 2009

Mr. Edward Pinto, Real Estate Financial Services Consultant

- In your testimony, you make the case that FHA loans are tremendously risky and that FHA will require a $54 billion bailout. To support your argument, you note that FHA will perform like Fannie Mae's 2006 high loan-to-value book (page 8). You make this assumption, then apply the default rates of Fannie Mae's 2006 high loan-to-value book to FHA's portfolio, and come up with a $54 billion figure.

    - How do you come to the conclusion that Fannie Mae's high loan-to-value 2006 book of business is the same as FHA's current book of business given that FHA requires full documentation on all of its purchase and new refinance transactions, FHA does not allow zero downpayment or piggyback loans and FHA stopped investor loans many years ago?

      Fannie's book of high loan-to-value loans is or has:

      - **93% fixed rate;**
      - **97% principal residence;**
      - **An average FICO of 690;**
      - **An average loan size of $130,000;**
      - **An average LTV (1st mortgage) at origination of 97.4%;**
      - **A "normal" interest rate;**
      - **92% were not classified as Alt-A;**
      - **0% were negatively amortizing; and**
      - **94% were fully amortizing.**

      It is my opinion that this is a reasonable proxy for FHA's book.

- Please provide the data and methodology you used to calculate the estimated $54 billion needed by FHA.

  In my opinion, it is reasonable to assume that FHA's book will perform similarly to Fannie Mae's 2006 high LTV book of business. I estimate Fannie's ultimate cumulative default rate on its 2006 high LTV book be about 20% of insured loans. This estimate is based on Fannie's published data on the development of the cumulative default rate for its 2006 book, with further analysis done by me to compute a projected cumulative default rate for Fannie's 2006 high LTV book.

  Commissioner Steven's largely confirmed my projected cumulative default rate of 20% when he indicated that the 2007 and 2008 books were projected at 24% and 20% respectively.

  Applying this estimate of a 20% default rate to FHA's current book of 5.8 million loans yields 1.2 million new foreclosures. Fannie is experiencing a loss rate per default of an estimated 50% of principal on its high LTV defaults. It is my opinion that FHA's loss rate per default will equal or exceed 50% of the insured loan balance. This would amount to total losses of 10% on its $725 billion book of insurance or $72 billion in losses. FHA's average premium stream per loan is about 4.5% (based on 1.5% paid at origination and an average life of 6 years). This yields a shortfall of about 5.5% on its $725 billion book or $40 billion. FHA also has a Capital Reserve account requirement of 2% or $14.5 billion.

- You note that your assessment of FHA's capital reserves will likely differ from FHA's independent actuarial analysis because FHA's independent actuarial analysis uses overly optimistic assumptions. Which assumptions do you believe are overly optimistic? Have the independent actuarial reviews of FHA's capital reserve ratio, as required under the Cranston-Gonzalez National Affordable Housing Act, historically been overly optimistic?

  I am of the opinion that the review's assumptions will be overly optimistic relative to:

  - **The expected delinquency rate on the FY2009 book;**
  - **The cure rate on defaulted loans (all books);**
  - **The success rate on loan modifications (all books); and**
  - **The positive impact of FHA's recent and expected underwriting changes.**

- You estimate that FHA's foreclosure start rate is approximately 4.4 percent for 2009. However, Mortgage Bankers Association data published at the end of August indicates that FHA's foreclosure start rate was 1.15 percent as of the end of the second quarter of 2009. That is compared to a foreclosure start rate for prime loans of 1.01 percent and a foreclosure start rate for subprime loans of 4.13 percent. How did you arrive at your figure of 4.4 percent?

  The MBA reports a quarterly foreclosure start rate, which is not annualized. I estimated FHA's annualized rate for 2009 at 4.4%, based on a Q.1:09 rate of 1.1% and a Q.2:09 rate of 1.15%. Based on the first 2 quarters, my estimate of 4.4% seems reasonable.

- If FHA's downpayment requirement were increased to your recommendation of 10 percent, how many current FHA borrowers would not have qualified for homeownership?

  - What would be the current level of the FHA capital reserve ratio if downpayment requirements had historically been 10 percent?

  - What research have you conducted to support your assessment?

I would raise the minimum FHA downpayment on home purchase loans to 10%, reduce seller concessions from 6% to 2%, and tighten other gimmicks that distort home values. A major goal of single family affordable housing programs is wealth building through homeownership and equity build-up. Many will say, be reasonable – only drop to a 95% LTV but not to 90%. It is the lack of skin in the game by large numbers of borrowers in neighborhoods that is both a major cause and a continuing contributor to housing price instability – both in creating a bubble on the way up and a bust on the way down. This explains why FHA's foreclosure rate has been increasing for 60 years. Unprecedented levels of risky FHA financing have now spread to virtually every neighborhood in the U.S. Twenty years ago I dubbed the impact FHA has on neighborhoods, "the FHA effect". Real estate is fundamentally cyclical and borrowers (particularly low and moderate income ones) need staying power in the form of equity, fixed interest rates, good credit habits, and debt ratios that allow for some cushion. With FHA lending becoming more and more the norm, it will impact the price stability of more and more neighborhoods. When a neighborhood comes under stress, foreclosures rapidly soar if there is little in the way of collective equity among all households. When a homeowner with little equity looks out the window, he sees a sea of for sale signs. As distressed homeowners and properties increase and demand plummets, prices have nowhere to go but down. Those with equity have staying power, those without must join the rush to the exits.

I have also suggested that FHA's dollar limit be reduced to a level commensurate with its low and moderate income housing mission. In my opinion, FHA should serve households with an income less than or equal to 80% of the median. While regional adjustments would be appropriate, nationally this equates to an income of $54,000 and below. A household with an income of $54,000 getting a 6% fixed rate 30-year mortgage could afford the median priced house in the US – about $175,000.

I have also suggested that prospective homeowners without the requisite 10% down be encouraged to participate in a 5-year downpayment savings plan. They would be asked to establish a five year savings plan based on saving $25 - $35/week. Over 5 years a total of $6500 - $9100 would be saved. Add in interest earnings at 3% and an employer match perhaps through a 401k or a foundation grant and the total grows to $15,000 - $20,000 at the end of 5 years, enough for a 10% downpayment on the median priced home ($175,000). At the end of five years, this prospective homeowner has accomplished much, having saved a substantial downpayment, established a banking relationship and savings pattern, hopefully established a solid credit history and is now in a position to buy a home. The bank holding the saving plan account would be a suitable lender.

I have also suggested limiting FHA's volume of low downpayment loans to a 10% market share so as not to distort the housing market and home prices and requiring FHA lenders to also have skin in the game through a coinsurance requirement of perhaps 10%, backed by adequate capital requirements.

These steps will provide more consumer protection, reduce defaults to a more acceptable level, help police FHA's lenders and reduce fraud far more effectively than other suggested methods.

NID HOUSING COUNSELING AGENCY
A HUD APPROVED ORGANIZATION
NATIONAL OFFICE
25 YEARS OF 25 EXCELLENCE

October 8, 2009

Honorable Maxine Waters
Chairwoman
Subcommittee on Housing and Community Opportunity
House Committee on Financial Services
2344 RHOB
Washington, D. C. 20515

RE: Future of FHA, Implications for Homebuyers

Dear Chairwoman Waters:

The Federal Housing Administration (FHA) single family Mortgage Insurance Fund is now near or at its congressionally required 2% minimum capital reserves level, enacted to insure the actuarial soundness of the fund. The FHA share of the home loan mortgage market has grown from 3% to 24%, and from approximately 15% to 80% for urban areas and minority homebuyers over the past three years; as reported by the National Association of Real Estate Brokers (NAREB), the largest and oldest minority real estate trade association in the nation, in 8-09. NAREB has tracked these trends and their implications since 1947.

The temporary rise in FHA/GSE home mortgage loan limits has had a positive impact for homebuyers in FHA designated "high cost areas" but less so for the urban and minority homebuyer market areas of high cost areas. The traditional urban area is more and more being defined in a broader geographic manner, with the boundaries now more representative of the traditional Metropolitan Statistical Area (MSA). This is a welcomed and justifiable dynamic, assisting in lessening urban core blight, the concentration of families living in poverty in the old traditional core urban areas and promotion of MSA smart growth planning and redevelopment initiatives.

Private sector convention home mortgage loan efforts under the Community Reinvestment Act (CRA) and or traditional private sector home mortgage lending practices remains unfair and unequal as disclosed by empirical and historical Home Mortgage Disclosure Act (HMDA) and U. S. Census Bureau data. There are those who falsely blame the subprime lending crisis and the failure of Fannie Mae and Freddie Mac on their efforts to increase home mortgage lending capital to minorities and in urban areas. Access to home mortgage capital has been subjective and sometimes discriminatory, based on race and location, as noted by numerous credible sources.

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The only reasonably reliable source of fair and safe home mortgage capital for minority homebuyers and core urban areas historically originates from and continues to flow from the FHA Home Mortgage Insurance Program. The traditional suite of products offered by the FHA program, including but not limited to, 203-b and 234-c original and refinance loans for 1-4 units and Condominium-respectively-homebuyers, 203-k-Acquisition/Rehabilitation, 203-h-Disaster Area mortgage borrowers/homebuyers, HECM-Home Equity Conversion Mortgage, Title 1-Manufactured Housing and Property Improvement, etc., have been and remain the most relevant, fair, safe and affordable access to home mortgage capital for minority homebuyers and core urban areas.

It is critical that Congress holds HUD/FHA accountable in assuring minority homebuyers and urban areas maintain adequate access to home mortgage capital. That home mortgage originators have urban and minority market area knowledgeable and culturally sensitive professionals providing the professional services needed to originate and underwrite the loan and appraise/valuate the property (and area) that is securing the loan. Pre and Post Purchase Housing Counseling should be mandatory for first-time high LTV mortgage borrowers; historical data affirms that P/P housing counseling dramatically reduces the occurrence of mortgage delinquency and foreclosure.

Congress should not leave the only option for the FHA insurance fund to remain solvent to stricter underwriting standards and higher mortgage insurance fees, traditionally employed under standard risk management options. Such options are counter to the mission of HUD/FHA and create the platform for de-facto discriminatory practices in the minority and core urban home mortgage lending marketplace.

Madam Chairwoman, NID-Housing Counseling Agency looks forward to working with you, your committee, the real estate industry and HUD/FHA to develop regulation/practices that will assure the soundness of the FHA Insurance Fund while also assuring access for minority families and core urban areas to fair and affordable home mortgage capital.

NAREB-Investment Division (NID) and the 53 urban communities in 22 states that we have served for 25 years thanks Chairwoman Waters and the House Financial Services Subcommittee on Housing and Community Opportunity for addressing the critical issues of the continued soundness of the FHA Insurance Fund and Fair and Affordable Access to mortgage capital for the Urban and Minority Homebuyer.

Sincerely,

Jacqueline Carlisle
Executive Vice President, NID

Testimony of Dr. Andrew Caplin

Professor of Economics
Co-Director Center for Experimental Social Science

New York University

Before the House Committee on Financial Services
Subcommittee on Housing and Community Opportunity

For the Hearing On
"The Future of the Federal Housing Administration's Capital Reserves: Assumptions, Predictions and Implications for Homebuyers"

October 8, 2009

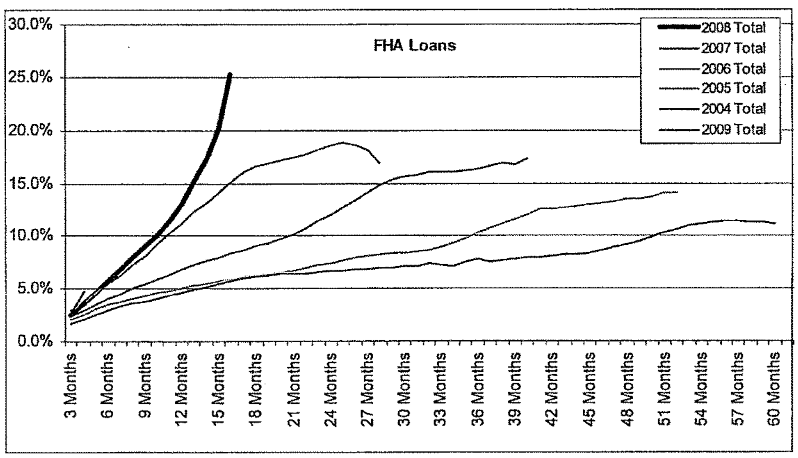
EXECUTIVE SUMMARY

The Federal Housing Administration's Single-Family Mortgage Insurance Program (FHA) is on an unsustainable path. Current policy will call for massive new infusions of capital, while failing to create any durable solution to problems of housing affordability. Given this, it is hard to see how additional reserves would represent a wise use of taxpayer money. It is past time for the FHA to introduce new methods of support for homeownership. Shared equity homeownership provides one such innovative solution that must be considered by FHA to preserve sustainable homeownership. Its introduction would improve the affordability equation while avoiding the excess leverage that has characterized the mortgage marketplace in recent years. There may be time to move to such a more sustainable path, but only if changes are made with great urgency.

FHA LOANS ARE BECOMING DELINQUENT AT AN ALARMING RATE

The current crisis began with the freezing up of credit markets and a reassessment of risk. The supply of mortgage credit to households in the U.S. had been premised on a continuing path of house value increases. When this came to an end, the highly risky nature of recently-issued mortgages became obvious, and those who had supplied this credit to the market took a massive beating. Trust has yet to rebuild, resulting in the withdrawal of private capital from the high loan-to-value (LTV) lending that it had come to dominate.

To fill this hole in the market, the FHA ramped up its program of high LTV loan issuance. Issuing a highly risky 95%+ LTV loan in an economic recession into a falling housing market is a dangerous game. It helps neither the borrower nor the lender, who both risk catastrophic losses. In confirmation of concerns that newly issued FHA loans would not perform well, 60 day plus delinquency rates have ballooned. Recently released data from First American CoreLogic (its most recent Market Performance Report for media) suggests that after a year of life, more than 15% of FHA loans issued in 2008 are already 60 days delinquent. This figure was as low as 5% for the 2005 vintage. While not sufficiently seasoned, the 2009 issuance is already on an even worse path. The current figures are astonishingly bad, as bad as "sub-prime" loans at their very worst.



60-Day Plus Delinquency Rates by Months since Issuance for FHA loans of Different Vintage

In large part the delinquency problems on FHA loans were predictable given market conditions. The reason the private sector has pulled back so far is because lending in the current period is uniquely dangerous. Why would one issue a 96.5% LTV loan in a housing market in which current house values are hard to assess, are likely to fall further, and in which unemployment is rising? Who does this help? The high levels of default that will result from this policy are entirely predictable, and cause great damage to the borrowers and their broader communities, with huge costs passed on to taxpayers.

But it is worse than that: part of the problem is that loan volumes were expanded without adequate diligence. Predictably, this has caused major quality control problems. If, as it appears, laxly underwritten debt has been issued into an extremely fragile market in the name of volume, then we are in a perilous situation, at least as bad as that we were in two years ago prior to the onset of the sub-prime crisis.

THE FHA MIGHT REQUIRE A MASSIVE INFUSION OF TAXPAYER MONEY

The extent of losses on FHA mortgages depends on the path of future house prices. If policy makers get lucky and house prices rise significantly and employment recovers quickly in the coming years in most parts of the country, losses may flatten out. If this does not happen, there will be massive losses and all the problems with loan quality will be revealed. Here there are profound reasons to worry, in particular given the interaction with other federal policies, including current mortgage modification programs, all of which have high recidivism rates and are likely to stretch out the downturn. If house prices and the broader economy do not turn around quickly, these policies will serve only to delay foreclosures to a point at which the properties are in even worse condition and must therefore be sold into a market that has deteriorated further. Many are pessimistic about the medium term prospects for recovery of the housing market. The "shadow inventory" of impending foreclosures will likely drag many housing markets down in the coming years. While some markets will perform well due to strong economic fundamentals, others may not recover in the foreseeable future. In turn, the failure of the housing market to recover will greatly hold back any broader economic recovery.

Given that house prices are not guaranteed to rise in the near future, FHA is massively under-capitalized and will require its reserves to be rebuilt at great cost to taxpayers. This next infusion itself will not last long unless the housing and employment pictures turn around quickly. If this turnaround is delayed, the only way the FHA will be able to cover future claims is to deny them on the grounds that the original issuance was not in fitting with published standards, hence non-qualifying. This would force the issuing institutions to absorb the losses themselves, causing them to seek more help from the federal government, pull back from future high LTV lending, and reduce lending to small businesses. No private capital is willingly being put at risk under this system, so all losses will ultimately reside with the taxpayer.

The bottom line is that, unless house prices rise and the economy recovers quickly, recently issued FHA mortgages will prove disastrous for the borrowers and for taxpayers alike. This will effectively end current affordability programs. Many will see the FHA itself as a symbol of waste, invalidating the good work it has done over the years.

SHARING OF EQUITY: A BETTER APPROACH TO AFFORDABLE LENDING

To be relevant in the future, the FHA needs quickly to turn to alternative housing finance models. My belief is that such models do exist, in particular those that focus on "equity sharing". I co-authored a book on the subject in 1997[1] and in 2007 and 2008 co-authored additional papers on the urgency of market development.[2] Knowing that actions speak far louder than words, I have now joined the Advisory Board of Primarq, a start-up that is dedicated to making shared equity markets a reality in the U.S. in the immediate future.

The housing finance industry, as we know it, is broken. Dating back to the New Deal, and the creation of the FHA, homeownership has been primarily financed through the use of long term debt. This was considered an acceptable risk for lenders and their guarantors, under the premise that home prices would sustain themselves during the loan period and macroeconomic conditions would be relatively stable. Over the last ten years, we have seen great volatility in house prices at the same time that lending standards were relaxed. With the recent declines in home values and rise in unemployment, lenders and their guarantors have experienced staggering losses amidst a continuing wave of foreclosures. Given that home equity represents the largest component of a household's net worth, the wealth destruction is and will continue to have severe consequences on the U.S. and global economies, in addition to destroying future access to credit for those who default on their mortgages.

Given the withdrawal of private capital from the affordable housing sector, it is vital to fundamentally change the form in which such housing is financed. We need new forms of capital to enter the system from outside the lending community. Additionally, such new capital needs to be able to both assess and voluntarily accept the risk of asset volatility. It is here that equity sharing enters the picture. Equity sharing is a method of housing finance in which an unrelated third party puts up money against owner-occupied housing. Rather than being paid back solely with interest, the payment to the supplier of equity finance depends on the open market value of the property in question, rising and falling with the value of the home.

The earliest equity sharing structure was the shared appreciation mortgage (SAM), which was briefly introduced into the U.S. market in the early 1980's in response to the then high rate of inflation. There is no interest due during the term of a typical SAM, but the lender receives back a proportionate share of any appreciation as interest upon termination, often at the point of final arms' length sale of the home. From the viewpoint of younger households early in the life cycle of earnings, affordability is enhanced by the fact that equity sharing reduces monthly payments and replaces them with a lump sum at termination. Moreover, the fact that the cost of equity finance is low when the house performs poorly and high when it performs well lowers risk.

SAMs disappeared from the market place with the decline of inflation in the mid 1980's. Only now is the failure of the high LTV loan market causing a reassessment and

[1]Andrew Caplin, Sewin Chan, Charles Freeman, and Joseph Tracy. 1997. Housing Partnerships: A New Approach to a Market at the Crossroads, MIT Press, Cambridge, Mass.
[2]Andrew Caplin, James Carr. Frederick Pollock, and Zhong Yi Tong. 2007. "Shared Equity Mortgages, Housing Affordability, and Home Ownership", Fannie Mae Foundation Special Report.
Andrew Caplin, Noël B. Cunningham, Mitchell Engler, Frederick Pollock. 2008. "Facilitating Shared Appreciation Mortgages to Prevent Housing Crashes and Affordability Crises." Hamilton Project Paper, September 2008.

recognition of the potential value of home equity sharing. This is spurring a new round of innovation in the space. Many believe that high LTV lending as it existed in the past will never return. That makes it imperative to seek entirely new sources of finance that offer the chance of homeownership without putting borrowers, lenders, and guarantors, at excessive risk. Most who start down this path end up believing that home equity sharing is the best way forward, and it is this that is producing so much fresh thinking.

The first major innovation that moves us beyond the limitations of early SAMs is rejection of the mortgage format in favor of "pure" home equity finance. This is far superior to the SAM in terms of sharing of losses, and therefore in terms of lowering risk. Consider a household buying a $200,000 home with a down payment of $20,000. Of the remaining $180,000, suppose that $20,000 is supplied using shared equity finance of some form, with the remaining $160,000 coming in the form of a standard mortgage. With the pure home equity finance, the $20,000 initial investment conveys to the co-investor (not lender) the right to a share of the housing equity, which is defined to be the value of the house over and above the original debt level of $160,000. Consider a simple case in which 1/2 of the value above $160,000 goes to the investor, 1/2 to the owner-occupier, in line with their initial contributions to the equity. The amount due the co-investor depends on the value of the home.

a. If the house is sold for $400,000, the homeowner pays the co-investor 1/2 of the $240,000 gap between final sale price and initial loan, amounting to $120,000 at point of termination.

b. If the house has stayed constant in value at $200,000, the homeowner pays the co-investor 1/2 of the $40,000 gap between final sale price and initial loan, amounting to $20,000.

c. If the house has fallen in value to $100,000, the homeowner pays back nothing at point of termination.

It is case (c) that shows the superior risk sharing properties of this form of pure home equity finance relative to those of standard mortgage debt. With a standard mortgage in amount of $180,000 on the $200,000 home, the borrower is under water when house values fall by any more than 10%. The same is true with a SAM, since the borrower by definition owes at least the original $20,000 that was borrowed. However, with pure equity finance, it takes a more than 20% decline in the value of the home to bring the homeowner into a negative equity position, since both the homeowner and the co-investor share all losses.

The above example illustrates in a nutshell why shared equity finance would produce such a massive advance in the ability of the housing finance system and of household finances to withstand shocks to the housing market. With pure equity sharing, any fall in the value of the home that wipes out the homeowner's equity by definition wipes out the co-investor's equity. This is the perfect way to supply affordable housing finance without putting the homeowner and the broader financial system at risk. Put in an equity investor who embraces the risk of a fall in house value in exchange for a large benefit if house values rise. The end result is that the lender and the FHA as insurer are in a far safer position.

In addition to helping homebuyers, there are important advantages of this form of finance from a capital markets perspective. Suppliers of shared equity finance would be explicitly investing in residential real estate returns. It has been known for a long time that investors would be attracted by this form of real-estate related asset due to their high diversification value. Interested investors would demand high-quality research into returns on residential real estate, and would therefore be aware of the risks they were taking. They would also pay attention up and down the supply chain to prevent buyers from being overcharged. Who wants to co-invest with a buyer who has been misled into overpaying for the home? There are social policy benefits also. It has been well argued that many problems of "NIMBYism" are caused by the excessive investment by homeowners in an individual property.[3]

The above explains the value of shared equity finance to the homeowner and to the broader society. The key to getting the market to function on a large scale is to get private capital flowing into the market. Fortunately, the advent of Web 2.0 is fomenting innovations that will enable all potential investors to trade in (virtual) market places. As in any orderly market, the organizers will set rules of conduct, ensure that all participants are well-informed, build up relevant informational resources, and seek to build reputations for excellence and integrity. A market would be designed not only to enable initial issuance of housing equity, but also to standardize and simplify contracts, and to set rules for secondary market trading.

In conclusion, there is no reason to doubt the importance of home purchases and homeownership for the economy. Yet the FHA is currently on an unsustainable path that will harm, not help, our economy in the long run. By enhancing affordability without creating excessive risk, shared equity finance will bring benefits to us all.

[3] Lee Anne Fennell, 2008, "Homeownership 2.0", Northwestern University Law Review, Vol. 102. Lee Anne Fennell, 2009, The Unbounded Home: Property Values Beyond Property Lines, Yale University Press. William A. Fischel, 2005, The Homevoter Hypothesis: How Home Values Influence Local Government Taxation, School Finance, and Land-Use Policies, Harvard University Press.