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ADDRESSING FHA'S FINANCIAL CONDITION AND PROGRAM CHALLENGES—PART II

HEARING

BEFORE THE

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

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE FHA'S FINANCIAL CONDITION AND PROGRAM CHALLENGES

FEBRUARY 28, 2013

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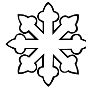

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ADDRESSING FHA'S FINANCIAL CONDITION AND PROGRAM CHALLENGES—PART II

THURSDAY, FEBRUARY 28, 2013

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

The Committee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order. Thank you to all of the witnesses for joining us for this important meeting.

I would like you all to help the Committee gain greater insight into the fiscal challenges at the FHA and what needs to be done to mitigate losses and address the shortfall in the capital reserve ratio.

We must also keep in mind that the FHA serves a critical role in our housing market by insuring affordable, fully documented, and underwritten mortgages for families across the country. Without the FHA, the housing crisis would have been much deeper with an estimated additional 25-percent decline in home prices, which, I am told, represents $3 trillion in lost home values. For this reason, we must ensure that the FHA is on stable footing and can continue providing loans going forward.

While the Fiscal Year 2012 Actuarial Report projected a negative capital ratio for the Mutual Mortgage Insurance Fund, this does not mean that the FHA will have to draw funds from the Treasury. We should learn more when the Administration releases its fiscal year 2014 budget in the coming weeks. But the decision regarding whether the FHA will need funds will be made by the OMB in September. That means that the Administration has a short window of time to develop and implement strategies to manage the FHA's old book of business and reduce losses.

As I said in the hearing on December 6th, if the Administration's actions and proposals will not be sufficient to restore the FHA's fiscal health, then I plan to work with my colleagues on both sides of the aisle on the Banking Committee to find a bipartisan way to make that happen. Before the last Congress adjourned, we tried to pass a bipartisan bill to give the FHA some of the tools it needs, but it was blocked by a small group of Senators. This Congress, I hope that Ranking Member Crapo and I can work together to reach a bipartisan agreement to ensure the FHA's fiscal stability.

I look forward to your suggestions for ensuring the FHA's fiscal health now and in the future.

With that, I will turn to Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman, and I do appreciate our work together so far with regard to the FHA reform and will continue to work with you as we deal with this critical issue.

Since its creation in 1934, our Nation has depended on the Federal Housing Administration, or FHA, to help first-time home buyers as well as low- to moderate-income Americans achieve their dreams of home ownership. There are undeniable benefits derived from home ownership for both families who buy and the broader community as long as the purchase of that home is achieved through responsible and sustainable means.

When the FHA operates in a safe, viable manner, it can help many deserving people gain a foothold in our housing market who otherwise might not have been able to do so. That is why today's hearing comes at such an important time for the FHA.

The taxpayers, who stand behind the FHA, as well as potential future home buyers, depend on the FHA, and they look to us now to enact reforms that will return the FHA to a sustainable path. If we do this, the FHA can remain a viable option for future generations. If we do not, the future is more uncertain.

The current situation surrounding the solvency of the FHA is concerning, to say the least, and, at worst, is unsustainable. Just the results of the most recent independent actuarial report, a negative economic value of more than $16 billion with a capital reserve ratio of a negative 1.44 percent would be problematic, even if they were only considered in a vacuum. However, nothing should be considered in a vacuum, and what is more troubling is that these numbers are part of a continued negative trend that we see in these reports year after year.

Despite assurances from the FHA that capital shortfalls were temporary, for the last 4 years, the FHA Fund has been in violation of statutory mandates for minimum capital levels. Worse yet, the capital reserve ratio has actually been in decline every year since 2006.

Perhaps worst of all, many experts believe that the FHA is actually underestimating its risk exposure. If this is true, the taxpayer could be even far more exposed to losses than is even currently estimated.

Unfortunately, this continued trend of declining capital leads one to the inevitable conclusion that the FHA has a fundamental problem building and maintaining adequate capital to protect the taxpayer. As such, it is our duty to look at a broad range of reforms aimed at returning the FHA to a strong, self-sustaining insurance program.

Many experts have told us that there is no one perfect solution that will fix all of the FHA's problems. Ideas such as strengthening indemnification provisions, examining premium structures, tightening underwriting, increasing transparency, increasing borrower equity, and reducing risk layering are just some of the proposals

that have been put forth by many experts in the housing community.

However, we should not kid ourselves that any one of these or any other suggested reforms by themselves represent an easy, quick fix to the solvency concerns at the FHA. Instead, what is needed here is for this Committee to come together, as the Chairman has suggested, and craft bipartisan legislation that will best equip the FHA to accurately assess its risks and build capital to assure against them.

Additionally, as the Committee responsible for oversight of the FHA, we must remember the FHA is an insurance fund, and the FHA needs to operate as such. Even as we deliberate additional authorities that the FHA may need, the FHA needs to fully utilize the authority currently at its disposal to ensure that it does not require a taxpayer bailout. While the FHA does that, hopefully this hearing can move us closer to this Committee taking action to improving the solvency of FHA.

Nearly every American has a stake in this hearing and in our subsequent actions. They may be a young family starting out and hoping to buy their first home, a retired couple looking to sell their home and move closer to their grandkids, or taxpayers worried about the consequences of inaction. Regardless of their situation, and whether they know it or not, nearly all of our constituents will suffer if we continue down this current path.

Mr. Chairman, I thank you again for holding this hearing, and as I said, I look forward to working with you as we move forward to find solutions. Thank you.

Chairman JOHNSON. Thank you, Senator Crapo.

Due to the size of our witness panel and to ensure ample time for questions, opening statements will be limited to the Chairman and Ranking Member. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit.

Now I would like to introduce our witnesses.

Mr. Gary Thomas is the 2013 president of the National Association of Realtors. Mr. Thomas is a realtor from Orange County, California.

Mr. Peter Bell is the president of the National Reverse Mortgage Lenders Association.

The Honorable Phillip L. Swagel is a professor in international economic policy at the Maryland School of Public Policy, University of Maryland. Dr. Swagel was Assistant Secretary for Economic Policy at the Treasury Department from 2006 to 2009.

Ms. Sarah Rosen Wartell is the president of the Urban Institute.

In just a moment, Senator Toomey will introduce Ms. Teresa Bryce Bazemore. Before that, we also have the Honorable David H. Stevens before us. He is the president and chief executive officer of the Mortgage Bankers Association and former FHA Commissioner from 2009 to 2011.

Senator Toomey, would you like to begin?

Senator TOOMEY. Thank you very much, Chairman Johnson and Ranking Member Crapo, for holding this hearing and also for giving me the opportunity to introduce my constituent, Teresa Bryce Bazemore.

Ms. Bazemore is president of Radian Guaranty, which is headquartered in Center City, Philadelphia. In that capacity, she oversees strategic planning and administrative activities designed to best position the company to achieve its long-term goals and objectives.

Before joining Radian in October of 2006, Ms. Bazemore served as general counsel, senior vice president, and secretary for Nexstar Financial Corporation, and prior to that she had a number of senior positions with various financial institutions. Ms. Bazemore holds a bachelor's degree from the University of Virginia and a J.D. from Columbia University. I am delighted that Ms. Bazemore could be with us today, and I look forward to your testimony.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you.

Mr. Thomas, please begin your testimony.

STATEMENT OF GARY THOMAS, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Mr. THOMAS. Thank you, Chairman Johnson and Ranking Member Crapo and Members of the Committee. Thank you for this opportunity to testify on behalf of the 1 million members of the National Association of Realtors who practice in all areas of residential and commercial real estate.

My name is Gary Thomas. I am a second-generation real estate professional in Villa Park, California, and I have been in the business for over 35 years and have served the industry in countless roles, and I currently serve as the 2013 president of the National Association of Realtors.

Throughout the course of my real estate career, I have witnessed the vital role that the Federal Housing Administration plays in providing access to affordable home ownership. Over the past 5 years, FHA's role has been more critical than ever as it sustained the housing markets nationwide during the worst economic crisis of our lifetime. FHA also helped sustain our national economy during this crisis. Without it, housing prices would have dropped an additional 25 percent, and American families would have lost more than $3 trillion of home wealth.

Yet numbers such as this only tell one side of the story. What is often missed is the human side of how these policies impact the lives of millions of Americans for the better.

As president of NAR, I hear countless stories from our members about FHA's positive role. I would like to share one that puts a human face on the program we are discussing today.

One of our members told me about a single father who was able to turn his life around through the help of FHA. He had relocated to North Carolina from a very depressed area of West Virginia. His savings had been wiped out due to the lack of steady employment, and his credit score suffered as a result of a painful divorce. The move provided him the opportunity for a good, steady job, and he wanted a stable home for his child. He worked with a lender to get his ratios in line and worked hard to save the 3.5-percent downpayment, plus more for his closing costs. He was able to purchase a ranch home with enough land to park his work trucks and enough room for his teenage son to spend time in a positive environment.

This father was caught between forces beyond his control with the depressed economy, yet he was taking as much responsibility as he could to move to an area where there were better income prospects. Without FHA, it would have been several more years before he could buy a home, which would also mean losing precious time in which to raise his son in a stable environment and begin rebuilding his personal financial security.

Stories like this are not the exception. These and countless more stories reflect the positive life-changing role FHA plays in the lives of those who benefit from this the most.

The National Association of Realtors welcomes a return of a robust private market, but we are not there yet. Now is not the time to lose sight of FHA's mission for the sake of encouraging greater private equity which will return on its own when extenuating factors such as regulatory uncertainty are resolved. Those buyers who are central to FHA's purpose are the ones most likely to be hurt by further changes.

For example, first-time home buyers who are the most likely to not be able to meet the 10- to 20-percent downpayment required by private lenders would suffer. Since 2009, FHA has insured mortgages for more than 2.8 million first-time buyers. Were it not for FHA, these buyers would not be homeowners, and 2.8 million homes would still be on the market.

Second, minority home buyers would also be hurt. Nearly 50 percent of African American, Hispanic, and Latino households rely on FHA to purchase a home. As a Nation, we are strengthened when opportunity is to be available to all. Now is not the time to make unnecessary restrictions.

Finally, the responsible home buyers would be punished. With the private market's lending standards tightened too far, the average credit score in the conventional market has risen to over 760. The average credit score that is denied is now 734. FHA's market share has risen because good borrowers are being denied credit. The National Association of Realtors supports changes that are vital to the solvency and strength of the FHA Fund, and we look forward to the return of the private market and a robust economy. However, any action to deliberately lower the FHA's market share could reduce the availability and affordability of mortgage credit and undermine the fragile real estate recovery.

On behalf of the National Association of Realtors, thank you for the opportunity to share our thoughts on how we can work together to ensure that FHA maintains its critical role for American homeowners.

Chairman JOHNSON. Thank you.

Mr. Bell, please proceed.

STATEMENT OF PETER H. BELL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL REVERSE MORTGAGE LENDERS ASSOCIATION

Mr. BELL. Mr. Chairman, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to discuss the Home Equity Conversion Mortgage program. HECM is a very helpful and versatile personal financial management tool that had considerable applicability when it was first authorized by Congress

and has become even more important in today's economic environment. As the country emerges from financial crisis, HECM provides a stabilizing factor for many households, enabling them to hold onto their homes and other assets until values recover, making it less likely that they will outlive their assets while covering the costs of longer life spans. Without HECM, hundreds of thousands of older Americans would be forced to sell their homes and move into nursing homes, become a burden on their families or the social welfare network, or not be able to afford their prescription drugs and other expenses.

My written testimony presents a historical perspective on the HECM program. It is important for congressional decision makers to understand that HUD has taken its role of stewardship for this program very seriously and has continuously worked with stakeholders to refine the program, as we have learned from experience.

Today the HECM program faces some stress. This is due primarily to the overall housing markets over the past few years and not attributable to flaws in the concept or design of the program. In fact, the design is quite clever, and those responsible for devising it back in 1988 should be commended for developing an innovative tool that was very foresighted.

The challenges the program faces are directly a result of the decline in housing values. The diminution in home values from 2009 through 2012 is the major factor causing stress. Because HECM loans rely entirely on the future value of the home for repayment, diminished values have an even more severe effect on reverse mortgages than on other types of mortgage loans.

Later books of business have a positive economic value. In the recent actuarial review, FHA has adjusted its expectations of future home price appreciation for these newer loans utilizing a more conservative estimate than that used historically.

With improvements we are seeing in home price appreciation plus the vastly improved outlook for more recent loans, we believe FHA has the opportunity to earn its way out of the negative estimate of economic value for the HECM portfolio, particularly if given the tools necessary to properly manage its risks.

One of the challenges in managing this program has been FHA's inability to move swiftly in making programmatic changes that would reduce risk and enhance financial performance. Reverse mortgages are a relatively new concept, and there has been a learning curve. Some lessons have been translated into program refinements while other helpful changes are blocked by procedural obstacles that leave HUD unable to move fast enough in making desired changes. The time-consuming route that HUD must follow to modify regulations hamstrings its ability to react to market conditions.

Changes to many aspects of the program must be implemented through a regulatory development process that can take up to 2 years. If HUD was granted the authority to modify the HECM program by mortgagee letter in lieu of rulemaking, program changes and enhancements can be implemented in a matter of months, not years.

Changes that FHA would like to implement and which the industry supports include establishing a financial assessment through

which lenders would ascertain prospective borrowers' abilities to meet their obligations under the loan, including taxes and insurance; requiring set-asides or escrows for taxes and insurance in cases where that appears to be warranted; and placing restrictions on drawdowns of funds.

Assistant Secretary Galante, in testimony before this Committee, and the 2012 Independent Actuarial Report on the FHA Fund both suggested that it would be helpful if Congress provided HUD with the authority to make such changes through the issuance of mortgagee letters. NRMLA urges Congress to quickly grant that authority to HUD.

The HECM program was made permanent in 1998, but there has been a statutory limit on the number of loans FHA is authorized to insure. Although the cap has been suspended by Congress on several occasions, its existence deters some lenders from making the commitment required to embrace reverse mortgage lending, keeping competition at a minimal level.

NRMLA urges Congress to remove the cap on the number of HECMs that FHA may insure to promote competition and eliminate any possible disruption in the availability of this important tool.

While there might be some concern about monitoring the program to assure it operates on a fiscally sound basis, the review undertaken annually through the budget process provides that opportunity. There are also opportunities for review whenever this Committee conducts its periodic oversight of the program.

HECMs have been a useful tool, helping hundreds of thousands of seniors maintain their homes and lead more financially stable lives. The program has been administered thoughtfully, carefully, and responsibly by a partnership of stakeholders. This has allowed the reverse mortgage concept to gain a foothold and prove the value of this tool for funding longevity.

I thank the Members of this Committee for your interest and urge Congress to grant HUD the authority to make programmatic changes swiftly and eliminate or permanently suspend the cap on the number of HECM loans that FHA is authorized to insure.

Thank you. I would be glad to answer any questions.

Chairman JOHNSON. Thank you.

Dr. Swagel, please proceed.

STATEMENT OF PHILLIP L. SWAGEL, PROFESSOR IN INTERNATIONAL ECONOMIC POLICY, MARYLAND SCHOOL OF PUBLIC POLICY, UNIVERSITY OF MARYLAND

Mr. SWAGEL. Thank you. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify.

The FHA mission is a good one, and FHA succeeds in important ways, detailed in my written testimony. But more needs to be done. Reform needs to continue to move forward in the face of the financial deterioration of the FHA.

The problems at the FHA reflect many things: the economy, the collapse of the housing bubble, but also the problematic underwriting, excessive market share, underpriced insurance, and inadequate risk management at the FHA.

Now, having said that, the FHA deserves a lot of credit, notably Mr. Stevens, for taking steps to address some of these problems. But legislation is needed to make further improvements.

An especially worrisome aspect of the FHA's strategy to address its problems is that the FHA views its outsized presence in the market as a source of profits and a path for the future. The analysis of the Congressional Budget Office makes clear that FHA insurance is still underpriced, meaning that this strategy is misguided. The FHA books a profit when it makes loans to riskier borrowers and with laxer underwriting terms than private firms are willing to make. That is part of its mission, but that does not mean that those are actual profits. The risk is there. The profits are illusory.

Properly accounting for the risks does not in any way reduce the merits of FHA activities. The mission is so important that, as a society, we should be willing to pay the costs. We should just acknowledge that they exist and not pretend that the risk is not there.

Reforms such as stronger underwriting are also intrinsically proconsumer in that they ensure that American families are in homes and mortgages that they can afford and sustain. My written testimony covers a number of reforms that I think would be useful, and many of these go beyond the measures considered last year in the FHA Solvency Act. I would say that more needs to be done than was in that legislation.

So, very briefly, the key reforms that I would propose and that are covered in more detail in my written testimony include:

Improve the pricing of FHA insurance. Again, the CBO analysis makes clear that the FHA underprices its insurance.

Require higher downpayments for riskier borrowers. It is good for both taxpayers but also for homeowners for FHA borrowers to rapidly accumulate equity in their homes.

I would also focus the FHA more closely on its mission. I think it is hard to defend the FHA's standing behind loans on $700,000 and more homes. That seems to me to be at odds with the mission of the FHA.

I would expand the FHA's indemnification authority so that the FHA can pursue claims against all lenders and all servicers. And, also, I would ensure that the FHA provides more clear guidance on the factors that will lead to an indemnification request. The FHA should have the tools to go after wrongful actions by everyone. Any lender, any servicer that does something wrong, they should face the consequences.

It is important to keep in mind, though, that this action is just a piece of the solution. It is not enough by itself to make the FHA solvent and sustainable.

My written testimony discusses these proposals and several others. The key is to both address the current solvency problem and to make changes that will safeguard future solvency. FHA reforms should not wait for broader housing finance reform. Instead, early action to bolster the solvency of the FHA can set the stage for additional reforms for Fannie Mae and Freddie Mac and for measures that will bring back more private capital into the housing finance system.

Thank you very much. I look forward to the questions.

Chairman JOHNSON. Thank you.

Ms. Wartell, please proceed.

STATEMENT OF SARAH ROSEN WARTELL, PRESIDENT, URBAN INSTITUTE

Ms. WARTELL. Chairman Johnson, Ranking Member Crapo, and Senators, thank you very much for the invitation to testify today.

For 20 years, I have worked on housing finance policy, including a 5-year stint as an employee at the FHA before my tenure at the National Economic Council at the White House. I know very well the critical mission that the institution performs, but I also know very well its challenges.

We should not be surprised that the performance of the FHA has deteriorated so severely given the worst housing downturn since the Great Depression. Some of the losses that the FHA experienced were inevitable—the result of FHA playing an indispensable, countercyclical role without which losses to the larger economy, homeowners, and taxpayers through the GSEs in conservatorship, as well as to the private mortgage insurance industry would have been far greater. But some of these costs could have been avoided if the FHA had had additional tools and authorities to act nimbly to manage, price, and mitigate risk.

Simply put, FHA's ability to contain losses is often constrained by the need to achieve new legislation or extended rulemaking. A private credit provider can adjust to changing market conditions and emerging evidence of risk to protect their shareholders. But FHA does not have that option to protect the taxpayers. Similar changes can take great time and effort, and in the interim, the fund loses billions of dollars unnecessarily. Two examples illustrate the problem.

From early on, FHA officials were skeptical of the seller-funded downpayment assistance programs, but proponents of the program were persistent. Volume grew, peaking at almost a quarter of FHA's activity. Finally, in 2007, HUD proposed banning these programs, and a final rule was delayed when the court found that HUD failed to follow the proper administrative procedures. Fifteen months after rulemaking began, Congress ended the program, which over its life reduced the net worth of the fund by $15 billion. The fund would have had a positive economic value at the last actuarial report if not for this program over its life. Once political pressures were overcome, the rulemaking proceeded comparatively quickly—15 months—but in the meantime, FHA insured thousands of these loans even though officials knew they would perform poorly and be costly.

Flaws in the HECM program also have proven costly for FHA. Losses continue to this day, long after officials have determined that changes to protect taxpayers and homeowners are required. It is indefensible.

These experiences suggest that Congress should give FHA officials more power to act quickly, with appropriate public notices and transparency, so that they can take steps to reduce taxpayer costs. In my testimony, I detail specific proposals, a few of which I will describe now.

First, provide the Secretary with emergency risk mitigation powers so that he or she may suspend issuing insurance upon making a finding that continuation under current terms exposes the taxpayer to elevated risk of loss and fails to serve the public interest. The emergency authority could be time limited, and Congress could at any time vote to disapprove the use of the emergency powers.

Second, you might also direct the HUD Secretary to develop and continuously improve early warning risk indicators. The Administration's proposal to you regarding legislative changes to the so-called Compare Ratio in my mind is too timid. You should empower the HUD Secretary to use any early warning indicator that evidence suggests is predictive of loss, provided that its use does not discriminate or otherwise violate the law.

It shocks the conscience that officials must continue to accept loans for insurance when they know that taxpayers are being exposed to unnecessary risk. FHA staff should continually refine its warning indicators, be transparent, and have the authority to limit participation when they see undue losses. Participants should challenge those determinations if necessary, but taxpayers and not program participants should get the benefit of the doubt.

Third, we need to authorize FHA to pilot new policies to test their costs and benefits before implementation, and, finally, there is an ongoing concern that FHA does not have the systems technology and analytic prowess to understand emerging risks. Congress can allow FHA to provide elevated compensation to attract risk management and technological systems staff and can give it authority to use insurance fund proceeds to invest in those critical risk management systems.

Looking forward, there is lots that we can do. The capital reserve must be replenished. I agree we need to reduce loan limits to better target FHA resources. HUD has a range of proposals that I detail in my testimony that I am supportive of and others that will be discussed by other panelists as well. But I have focused on this set of recommendations because they represent a fundamental shift toward proactive risk management, and I believe it is essential that we take that different approach so that FHA does not again become so perilously close to requiring taxpayer support. Without that, FHA will not be sufficiently strong to fulfill its important countercyclical role and provide sustainable home ownership to those who have few alternatives.

Thank you.

Chairman JOHNSON. Thank you.

Ms. Bazemore, please proceed.

STATEMENT OF TERESA BRYCE BAZEMORE, PRESIDENT, RADIAN GUARANTY, INC.

Ms. BAZEMORE. Good morning. I am Teresa Bryce Bazemore, president of Radian Guaranty, a leading private mortgage insurance company. For decades, FHA and private MI have worked together in the housing finance market to ensure that low- and moderate-income families could purchase homes, often their first home, with low downpayments. In fact, my first loan was an FHA loan for a condo, and so I have personally benefited from receiving both FHA and privately insured mortgage loans.

It is vital that we have both a strong MI industry and a strong FHA to support low downpayment lending in America. I greatly appreciate the Committee's invitation to talk about ways in which FHA can return to financial health and return to its traditional mission of supporting underserved borrowers.

By way of background, the private mortgage insurance, or MI, industry is the private sector alternative to loans insured by FHA. Private mortgage insurers help qualified low downpayment borrowers obtain an affordable and sustainable mortgage. When a borrower places less than 20 percent down, the lender is required to obtain private MI in order for that loan to be eligible for subsequent sale to Fannie Mae or Freddie Mac. Private MI typically covers the first 25 to 35 percent of the loss resulting from foreclosure.

Even during the recent challenging times, the MI industry raised over $8 billion in new capital, paid approximately $34 billion to the GSEs in claims resulting from foreclosure losses, and has reserved another $16 billion for this purpose. This is $50 billion taxpayers do not have to pay. We are able to pay claims at these levels in part because of the rigorous countercyclical reserve requirements imposed by State insurance commissioners. A requirement to reserve half of each premium dollar ensures that significant capital reserves are accumulated during good times and then drawn upon to absorb the losses during downturns.

Both FHA and private MIs found themselves at a disadvantage in the early 2000s. Their efforts to promote responsible underwriting of mortgages for first-time home buyers were undermined by the development of mortgage products, the purpose of which was to avoid the use of any type of mortgage insurance, whether FHA insurance or private MI. In order to remain in the market, FHA and private MI companies had to lower premiums and accept underwriting decisions of the GSEs and lenders.

Beginning in 2007, the GSEs, lenders, and private MIs tightened their own underwriting requirements and raised their premiums and delivery fees. Yet FHA did not. The result was that FHA received a flood of new mortgage originations, many of which were very poor quality.

I would like to offer five recommendations to improve FHA's financial health and restore its focus on its historical mission.

First, FHA should be authorized to enter into modern risk-share agreements with private mortgage insurers under which the private mortgage insurer will conduct an independent underwriting and take a first-loss position.

Second, FHA needs to refocus its eligibility requirements on income level to serve lower- and moderate-income borrowers who need their help, as proposed in the Administration's February 2011 white paper on housing finance reform.

Third, Congress should consider reducing the FHA's guarantee below its current 100 percent level, much like the VA mortgage program.

Fourth, FHA should be given additional authority to adjust its premiums to levels that reflect the true risk of the loans that it insures.

Fifth, the Government must avoid actions that unintentionally steer borrowers to FHA such as GSE guarantee fees and loan level

price adjustments that are not actuarially based. The result is to make privately insured loans purchased by the GSEs more expensive than FHA-insured loans, thereby steering borrowers to FHA loans.

In conclusion, I would also like to say that unless the QRM and Basel III rules recognize private MI as a risk mitigant, low downpayment borrowers will find it much harder to obtain a mortgage.

Thank you, and I will be glad to answer any questions.

Chairman JOHNSON. Thank you.

Mr. Stevens, please proceed.

STATEMENT OF DAVID H. STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, MORTGAGE BANKERS ASSOCIATION

Mr. STEVENS. Chairman Johnson, Ranking Member Crapo, Members of the Committee, thank you for the opportunity to testify on FHA's 2012 Actuarial Review and FHA's role in the single-family housing system. FHA has never played such an important role in the housing market today. FHA is virtually the sole source of mortgage finance for borrowers with low downpayments and those without high incomes or large amounts of inherited wealth.

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

Given FHA's importance, I want to commend the Senate for confirming Carol Galante as FHA Commissioner. Commissioner Galante has been a staunch advocate for housing throughout her career, and I know she will work aggressively to protect the taxpayers and the FHA Fund.

In 2012, the FHA Actuarial Review showed that the capital ratio of the MMI Fund had fallen to negative 1.44 percent. This prompted immediate concerns that FHA might need to draw from the U.S. Treasury and brought into sharper focus questions about whether the FHA's policies need to be adjusted.

FHA has already taken steps to address many of the causes that have led to losses in its single-family portfolio by raising mortgage insurance premiums, increasing downpayment requirements for certain borrowers, raising lender net worth requirements, reexamining the reverse mortgage policies, and establishing an Office of Risk Management. By making these changes, FHA has moved swiftly to protect the taxpayers and the fund. The credit portfolio and performance of the 2010–12 portfolios demonstrate the effects of these changes.

For a more historical context, consider this: According to the 2012 Actuarial Review, under the current FHA underwriting standards every endorsement year from fiscal years 2011 through 2019 is projected to have a cumulative claim rate of less than 5.7 percent. Prior to the 2011 book, no FHA annual book in more than 30 years has had a projected claim rate below 5.7. If loans were written at the low edge of the FHA's credit box today, performance could be worse than this. On the other hand, if FHA moves their credit standards to match those that lenders have in place today, the strong performance seen in the 2010–12 books of business should continue.

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

We are currently working on a white paper with our members, which we will be releasing next month, that evaluates the pros and cons of a variety of policy options to determine which ones offer the greatest impact to FHA while protecting its overall mission. A longer list is in my written testimony, but let me highlight just a few.

First, FHA's traditional underwriting philosophy takes the approach that individual risk components can sometimes be mitigated by compensating factors. Risk-based underwriting or specifying particular additional underwriting criteria or compensating factors within certain credit boundaries could further reduce FHA's risk.

However, the consequences to FHA's traditional borrowers could be significant if FHA employs overly stringent credit controls, so finding that right balance is critical.

Many lenders in recent years have tightened their standards beyond FHA minimums. FHA may need to lock in some of those overlays. This would protect FHA from any erosion in standards as market conditions evolve.

Also in recent years, FHA has increased its enforcement of agency approved lenders, and as FHA Commissioner, I initiated tighter controls and enforcement procedures that shut down irresponsible lenders like Taylor, Bean & Whitaker, whose chairman sits in prison today.

When lenders are forced to operate their businesses to near perfect standards, however, or potentially face substantial financial penalties, they will naturally restrict their underwriting to operate well inside of published standards, potentially limiting financing options for FHA's targeted population.

Mr. Chairman, with the housing crisis fading yet still fresh in our memory and the real estate and mortgage markets starting to recover, now is the time to have a thought, comprehensive debate over the future of the Government's role in the housing system. That includes not just FHA but examining the long-term role of Fannie and Freddie. Ultimately, all stakeholders want the same thing: a fully functioning market that relies mostly on private capital with a limited appropriate role for Federal programs. A stable, sustainable FHA program must be part of that system.

Thank you, and I look forward to answering your questions.

Chairman JOHNSON. Thank you, and thank you all for your testimony.

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

Mr. Thomas, in a recent meeting with realtors from my State, they mentioned that without fully documented, high LTV loan products with a Government guarantee, some communities will experience a 50-percent decline in the number of families buying homes today. Is this the case for communities across the country?

Mr. THOMAS. I believe it is. Especially in my area in Orange County, California, it would be devastating. You know, the lenders have not come back into the market like we would have wished

they had. And so FHA has fulfilled its role, and that is to fill the market when it is countercyclical.

FHA has a critical force in the market for several years now. If FHA had not been lending, many of our markets would have collapsed altogether, losing more home value and equity for American families. So I believe that it is true that we do need the upper limits.

The other thing is that those loans are performing the best of the book of business that the FHA has. And so to restrict that would be counter to what really FHA was put in place for. It was not just for first-time home buyers. It was for anybody that could qualify and responsibly own a home but could not get financing in any other place. And so it is fulfilling that role when the private market is not there.

Chairman JOHNSON. Ms. Wartell, a recent report in GAO's High Risk series recommended that the Congress evaluate what kind of market shocks the FHA should be expected to withstand. Do you think a 2-percent capital reserve ratio is appropriate? If not, what market disruptions should the FHA be prepared to withstand?

Ms. WARTELL. I think in the near term, Senator, it is important for us to get back to a 2-percent capital ratio, and our immediate effort has to be to strengthen and increase the level of that reserve.

I do think GAO is right that that number is not based on an understanding of the larger set of economic conditions. It was a relatively abstract—not quite pulled out of a hat, but an abstract number when it was first imposed. And I do think that we need to essentially set a higher target that allows us to buildup a cushion during the times when the economy is going well and resist the pressure to loosen standards too greatly when capital reserves are building up.

Having said that, I also worry about setting a number that is artificially so high that it forces FHA to overprice for its current insurance today and in doing that essentially cause borrowers to pay so much more than the real cost to the taxpayers relative to the benefit they are getting. And when you do that, you will eventually be adversely selected and actually create additional risk to the FHA Fund.

I think this requires a lot of analysis to set the right level, but I do think that there is some benefit to encourage a more robust accumulation of reserve during the better times.

Chairman JOHNSON. Mr. Stevens, when the housing market began experiencing distress, private capital withdrew from the market or became significantly more expensive, even for high-income families. However, this created greater distress in the market as it reduced liquidity. What would happen to credit availability and home values in a distressed market if the FHA were not able to step in because of statutory restrictions limiting its market?

Mr. STEVENS. Senator, I think that is a core question to the whole debate over the role of FHA. FHA was designed historically to—well, it has been argued that it was designed historically to be a countercyclical provider of liquidity to the housing finance system. Traditionally, we have never experienced historically a recession the likes of what we just went through that began in 2007, late in 2007, when home prices started declining.

The core fundamental here is private capital is opportunistic. Private capital will stay in the market when the investment opportunity is good; and when the risks are too great, such as experiencing a 34-percent peak-to-trough home price decline that the U.S. economy faced, private capital will exit the market. And in the absence of that, without some continuous form of liquidity, home prices would have dropped significantly further, and most importantly, for first-time home buyers and families without large amounts of inherited wealth, it would eliminate their access to housing overall.

Some could argue that that is maybe what the private market is supposed to do. The counter argument to that would be the broader impact to home price declines would be even greater. And the Center for American Progress recently put out a paper on this exact subject, as have others, and I think that is sort of fundamental to the role of what FHA needs to provide.

Chairman JOHNSON. Mr. Stevens, why is it important to stabilize FHA's finances first before we consider broad FHA reform?

Mr. STEVENS. Well, Senator, from my perspective, when you have 90 percent of housing finance being funded by three agencies, all backed by the U.S. Government, ultimately—Freddie Mac, Fannie Mae, and the FHA—and forget the other Ginnie Mae programs for a second—a policy change in one arena is nothing more than essentially squeezing a balloon. It expands the business in one of the other Government agencies.

So, for example, when Freddie Mac and Fannie Mae raise guarantee fees or loan level price adjusters, it just shifts business from those institutions over to FHA. When FHA raises mortgage insurance premiums, it shifts business back to the GSEs. We are doing nothing really fundamentally to bring private capital back into the market. We are just literally shifting the housing finance business from one Government-backed entity to another.

In order to move forward, while we talk about the future state of the GSEs, we have to stabilize FHA so that debate is off the table. FHA has to not be a point of adverse selection. They have to be safe and sound fiduciarily and well capitalized, and then we can simultaneously move on to the broader discussion of how do we deal with this overall housing finance interdependency between Freddie Mac, Fannie Mae, and the Ginnie Mae products.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Mr. Swagel, in your testimony, you advocate reforms that would increase the capital standing in front of taxpayer losses at the FHA, and you go about this in several ways, such as building capital at the FHA itself, building equity for the borrower, and introducing private capital into the loss equation in the event of a default.

Could you please explain just a little better why you feel this additional capital is necessary for the reform at FHA?

Mr. SWAGEL. Thank you. I think we have seen over the last couple years that the amount of capital at the FHA is insufficient. Even the 2-percent capital ratio, which the FHA has not achieved in years, is not sufficient. Other financial institutions, big banks, are being required, sometimes kicking and screaming but required,

to hold more capital. This is only appropriate now that we know how risky the FHA is.

There are many different ways to get private capital in there, so one is to have a program along the lines of the Veterans Administration, which has private capital taking risks ahead of the Government, and the Government does not insure 100 percent of the mortgage. And it turns out that the performance of VA loans is very substantially better than the performance of FHA loans, exactly what you would expect when the originator has skin in the game.

Senator CRAPO. Thank you.

Mr. Bell, I noted that you and several of the other witnesses indicated part of the problem is the lack of ability to move quickly at the FHA to deal with issues as they arise. And you indicated that you were facing that in the HECM program as needed reforms did not get implemented as efficiently as possible. Is that correct?

Mr. BELL. Yes, sir.

Senator CRAPO. Have you been working with the regulators to address the kinds of issues with the HECM program that you feel need to have this kind of prompt assistance?

Mr. BELL. Yes. As I said in my testimony, HUD has been a very proactive steward of this program over the years and has continually looked at what has been going on in the marketplace, drawing in information from the various stakeholders, from the lending community, from the counseling community—which is really the entryway into the HECM process—and has continually made changes to the program over the years, either requesting Congress to make changes or making changes itself. But it is hamstrung by the fact that certain things were written into the regulations when the program was created back in the 1980s in a much different era economically. And now to make changes to some of those types of items, they need to go through the formal regulatory development route, which is pretty much an 18-month to 2-year route.

We are aware of changes that could probably be done but for the regulatory development route in a matter of weeks or a couple of months through a mortgage letter. So we would recommend that they be given the authority to do that so that, as we all learn, changes can be implemented much more expeditiously.

Senator CRAPO. Thank you.

Ms. Bazemore, I would like to pursue an area with you relating to your testimony. Many experts have raised concerns with two specific aspects that they believe contribute to the current solvency problems at the FHA: one, the inadequate capital and a lack of enforcement of minimum thresholds; and, two, the method of accounting which shows that the FHA is actually in a better financial standing the larger it grows, regardless of risk.

When properly administered, the FHA is a Government-run mortgage company or institution, and clearly, in managing a privately held mortgage insurance company, you have got to have some expertise in this area. What are your views on these concerns? And are there any additional concerns that you think we need to note as we focus on the insurance function at FHA?

Ms. BAZEMORE. Well, I would say, with respect to the private mortgage insurance business, that we are required to keep a number of different reserves. And I think, you know, as you think about

the FHA maybe looking at some of that would be helpful. Obviously, in a first-loss position behind the borrowers, you know, we have taken a considerable hit during this timeframe. And I think the reason why many of us have been able to survive through this and to continue writing business and to pay claims is because we are required to reserve 50 percent of every premium dollar, and typically that we have to keep for about 10 years. So that allows us to sort of get our reserves up during the good times for the bad times.

The other thing is that as loans go into default, we are also required to have loss reserves that estimate the amount of what we think we will ultimately pay. So when I talked in my testimony about the $16 billion that is reserved, that is loss reserves that we believe will be paid out based on the current defaults at loan inventory. And so I think looking at some of those kinds of things might be helpful in terms of understanding how maybe best to work with the FHA.

Senator CRAPO. Thank you.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you very much, Mr. Chairman. Let me first commend you and Ranking Member Senator Crapo on the serious, thoughtful, and collaborative way you are approaching a very challenging issue. Thank you. And I thank the panelists for their excellent testimony.

Ms. Wartell, when Secretary Donovan was here, he talked about the early books of business of the FHA being really the source of some of the significant problems today. For example, he said fully $70 billion in claims are attributable to the 2007–09 period. Beginning in 2010, for many reasons, the books seem to be a lot better.

I think you referred to this as the diversification factor going forward. Can you comment upon the significance of this factor as we contemplate changes?

Ms. WARTELL. Sure. In some ways——

Senator REED. Do you have the microphone on?

Ms. WARTELL. I am sorry. It appears to be on now.

Senator REED. It is on, yes.

Ms. WARTELL. This was what I was trying to describe when I was speaking with Senator Johnson. In all insurance, it is inevitably the case that there are times when the insurance portfolio is under stress, and what you are in essence doing is you are creating a strengthening of the fund in the times when it is not under stress to be ready for that moment. So it is almost always the case that you buildup a reserve in times you effectively charge more.

With FHA it has the ability—at the time when private capital flees, better quality credit risks are left in the market unattended by the private institutions because they are so risk-sensitive when they are under pressure, and that allows FHA to serve more of that market and replenish its fund.

Former FHA Commissioner John Weicher, who is now at the Hudson Institute, has drawn the parallels between what happened between 1980 and 1982 when FHA took an enormous bath, had claims that even for much smaller books of business were well in excess to what they experienced in 2007. And yet they had this significant success in rebuilding the capital strength in the years after

as the economy improved. And he is predicting we will see a similar pattern.

Senator REED. Well, thank you very much.

Mr. Thomas, thank you for your testimony. The realtors are sort of on the front lines of all these issues. I was particularly struck by the FICO scores of people being turned down. They used to be sort of the ones that you were looking for first. But you suggest, I think, in your testimony that FHA has provided valuable assistance to this recovery, but we are not quite there yet. Could you elaborate on that point?

Mr. THOMAS. Sure. You know, as I said, the FHA average FICO score is 699, and the denial is at 670. But on the private side, the average is 763 and denying at 734. So it is very, very high, as you mentioned.

Without FHA being there, you know, we would have been in a world of hurt. We would have seen the equity fall another 25 percent. That would have been devastating to the economy.

We are climbing out of it now, and the private capital is not back in yet, and a lot of that is just because of the regulatory uncertainty out there, and they do not know what they are facing. And so until we get things to a certain standard, I do not think we are going to see private capital come back in. They have not come back in in the condo market. They have not come back in in the high-end market as yet. You know, if you go above FHA's upper limit, you have to put 40 percent down. It is not a normal 20 percent down. And so that is telling you that the private capital is not coming back in yet in any way that would be sustainable.

Senator REED. Thank you very much.

And just quickly, Mr. Stevens, there have been some suggestions that the FHA—in fact, they have requested the authority to transfer mortgage servicing to a mortgage servicer better equipped to handle loss mitigation so that they can be not just foreclosing but actually helping people through this. Do you have any comments about this, given your experience as a former director, administrator?

Mr. STEVENS. So we have seen this with Freddie Mac and Fannie Mae transferring servicing as well, some voluntary, some not voluntary. I do believe at the end of the day that, given the fact that FHA retains the risk and Ginnie Mae explicitly with the insurance coming from FHA, the ability to manage the quality of the servicing portfolio is absolutely critical. So with the right measures in place and the right balances to ensure that it is done in an appropriate way, with the resources to do the oversight, which is the biggest risk to having them take on more responsibility, I would support a measure along those lines, absolutely.

Senator REED. Thank you very much, Mr. Stevens.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I appreciate it. And I thank all of you for your testimony.

Mr. Bell, I was interested in your comments about the mortgagee letter and the ability to make changes in a more rapid manner. Candidly, we would be very open to looking at that if others on the Committee wanted to do so.

But, on the other hand, in the last couple months, I guess, we were able to do away with an entire program, the full-draw, fixed-rate reverse mortgage, by mortgagee letter. So I am a little curious as to what the impediments are, if we were able to do away with a whole program with a mortgagee letter, why we cannot make other changes in that regard now.

Mr. BELL. I agree, Senator, that is a bit of a puzzlement. But essentially there are certain aspects of the program that are written in the regulation, and it has been the opinion of HUD's counsel that items that are in the regulations must be changed by a modification of the regulations, which requires the formal regulatory procedure route; whereas, other aspects, such as the moratorium that has been put in place, the loan-to-value ratios, the principal limit factors, are not explicitly spelled out in the regulations, so, therefore, HUD feels that they have the discretionary authority to change such items by mortgagee letter.

They feel that some of the items that they could do by mortgagee letter right now are more blunt instruments and perhaps do not really get explicitly at the problems they need to address; whereas, items that are in the regulations would allow them to fine-tune the program to recognize the way that these loans are used in today's economy versus what was originally thought 20-some-odd years ago.

Senator CORKER. I certainly would be myself willing to look at that, and my guess is, based on the body language, other Members would.

Did you agree with the changes that were made, by the way, in the full-draw, fixed-rate reverse mortgage program?

Mr. BELL. I think that was a good stop-gap measure for the time being. However, I do think that there is a place for a fixed-rate, full-draw loan in a number of circumstances, or at least for a full-draw loan. There are cases where people need that full amount of money to pay off their existing indebtedness and get themselves on a sound financial footing to be able to sustain themselves for the longer duration of lives.

You know, the challenge we have in this country is growing longevity. People are living much longer than anticipated and retiring earlier, sometimes not by choice. And we need to sustain ourselves for a much longer duration of time after employment than we have ever had to before. And home equity is an important component for doing that.

Senator CORKER. Yes. I suppose people in our age group like that trend.

[Laughter.]

Senator CORKER. I noticed the Chairman, Mr. Thomas, asked you the question about loan limits at FHA, and because of the industry that you are from, that my mother was a part of, I am sure you would love to see the loan limits at a million, or two, even, at FHA. It would be very helpful.

To Mr. Swagel and Mr. Stevens, where do you think the appropriate loan limit level should be postcrisis, huge reduction in home values around the country? I think we are still using average rates based on 2008. Where should we really be to be in a healthy place with a Government program like this?

Mr. STEVENS. Senator, I mean, the loan limit is clearly a core debate around FHA. It is not as much as a risk debate as it is a mission debate. It is how large should FHA be and are they really serving their role when they are doing $729,000 loans with a low downpayment.

In the 2012 Actuarial, loans over $500,000 were less than 2 percent of the originations, and loans over $400,000 were about 3.5 percent. So it is a very small percentage of the portfolio with concentrations in places you would expect, like Washington, DC, and California.

Senator CORKER. Orange County, I would guess.

Mr. STEVENS. Orange County, right. So the real question is: What should that loan limit ultimately be set at? The bipartisan Housing Commission just recently published their recommendation to be below $300,000. My only sense of this is that it will need to scale back, and it needs to be done in a path that tests to make sure private capital is entering that space or other alternatives. But it is clearly too high. The absolute number, Senator, we could debate within a range, but it is clearly serving a larger portion of the market than it should from the historical perspective.

Senator CORKER. And, Mr. Swagel, I have a sense you are in the same area, generally, and I have a little bit of time left, so I will ask one last question. Actually, to both of you, and you may want to start, but should we—I know there has been a lot of discussion about QRM and QM being synched up, and I was glad the Chairman of the Federal Reserve actually addressed regarding that yesterday or the day before. Should FHA's underwriting also be synched up to QM? Actually, if both of you would respond briefly—I know my time is out—I would appreciate it.

Mr. SWAGEL. OK. Sure, very briefly. I think there is a strong case for that. We do not want private lenders not to make loans to people with greater than 43 percent DTI and then FHA to say, well, look, we will take those loans. So we do not want the risk to migrate to FHA, and I am afraid that will happen if those standards are not in synch.

Senator CORKER. Yes.

Mr. STEVENS. I agree generally on the underwriting criteria. I think there is an APR calculation in the qualified mortgage rule that impacts FHA uniquely because of their high mortgage insurance premiums up front, and you would quickly exceed the cap and push that into a non—a QM but with rebuttable presumption space. This is one variable we are discussing with the CFPB, but generally the underwriting criteria should approximate that of the rest of the QM rule.

Senator CORKER. Well, I thank all of you for your testimony and being and, Mr. Chairman, for having the hearing.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Bell, I heard some of your answers with reference to the HECM program, and I have legislation to basically take the authorities that exist, streamline it, and move forward. My question is: What would be the effects of not having a HECM program? And would the consolidation of the fixed-rate HECM standard and Saver Program generate savings for HUD?

Mr. BELL. I think the problems that we would see of not having the HECM is we have preserved the ability of hundreds of thousands of families to be able to stay in their home, jettison burdensome debt, and be able to adjust their cash-flow so that they can continue to sustain themselves, maintain their homes, meet their obligations, and continue living in homes that they have brought their families up in, in communities where they have had roots for many years, and where there might not be alternatives for them to move to.

Now, in terms of combining the two, for years we made almost exclusively variable rate loans. There were some developments in the marketplace, particularly the entrance of Ginnie Mae, that facilitated our ability to provide fixed-rate HECMs, and by and large, consumers prefer fixed-rate loans. Who would not? You know, everybody who lived through the 1980s—and certainly our population has, our clientele has—understands that interest rates could change and people do not want to be hit with surprises in the twilight years of their life. I closed on my home in September 1981, the day prime hit 21. My first mortgage was 16⅝ percent. Today I am about to close a loan at 3.75 percent. So there are a lot of people that understand that and, therefore, prefer the fixed rate. So I think it would be a shame to take the fixed-rate option off the table because it does give people peace of mind at a point in their life where they really do need peace of mind.

Senator MENENDEZ. So you are not for having the consolidation of the fixed rate and Savers Program?

Mr. BELL. I think all options should be left on the table. The challenge with the fixed rate has been that in order to get the fixed rate, the borrower must draw the entire amount of funds available to them. And the reason for that is if you want all the money today, I know my cost of funds today, so I could give that all to you. If you want to take part of it out today and then come back to me at some unknown point in the future for some unknown amount of funds, I cannot price that. I do not know how to hedge that. So, therefore, for fixed rate we require the full draw, and that has required some people to draw down more than they actually need.

Part of the flexibility that FHA seeks would be the ability to limit the amount of money that people would take on a fixed-rate, full-draw loan. They would be limited to perhaps the amount——

Senator MENENDEZ. Well, I think our legislation would deal with some of this, and we look forward to——

Mr. BELL. I understand it would, and we thank you for taking the deep look into this topic that you have.

Senator MENENDEZ. Mr. Thomas, let me ask you, you know, I think it has been broached here that the average FICO score with FHA was 670, well above that that is defined as subprime. You know, to me that demonstrates FHA is taking a more proactive stance on ensuring lenders originate quality loans. So how would a reduction, for example, in FHA market share affect high-cost regions and areas with higher density of condominium markets? And what would the suggestions of some on dramatically changing FHA's mission mean to the marketplace?

Mr. THOMAS. Well, it depends on when it is done. If it is done as the private market comes back in, then I think we can handle that. We really feel that, you know, FHA's footprint should be in the 10- to 15-percent range, not where it is today. But we need to get back to that responsibly. If we were to reel it back in immediately, it would leave—you know, it would have a devastating effect on home values and ability to buy.

What we need to do is do it over time and get it back into the range that it should have been in and it historically has been in. If you look back at when we had the—the housing bubble was inflating, FHA was down to 3 percent of the footprint. And so, you know, that should have given us an indication that there was a problem out there.

Likewise, the problem we see right now with the size of FHA tells us there is a problem at the same time, but in a different case, and that is that we do not have the private capital back into the market. So we need to have that back in before we start ratcheting it downward.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thanks to all of our witnesses.

I continue to have two really strong concerns with FHA: first of all, its fiscal situation and an impending taxpayer bailout, which I am pretty convinced is coming; and, second, a separate concern is a dramatically increased footprint and mission, and the prospect that that is permanent, not temporary. So let me ask questions in both those categories.

It seems to me there should be some no-brainer things we can do to shore up fiscal solvency, and one is indemnification language so that the taxpayer is not on the hook for fraud, misrepresentation, and not meeting proper criteria at origination—the same thing private insurers do and others. Does anyone disagree with full, broad indemnification language like that? And, Ms. Bazemore, you have some experience with that on the private side. Why don't you explain the difference that would make?

Ms. BAZEMORE. Well, I think, first of all, the way we look at it, we pay 100 percent of legitimate claims.

Senator VITTER. Right.

Ms. BAZEMORE. However, we do not pay for fraud or misrepresentation or failure to do a loan in accordance with our guidelines. And we believe paying for such claims would create moral hazard, so that is how we have approached it.

Senator VITTER. Great. Second, as you all know, FHA is insuring 100 percent of the loan, and that is just way beyond any competitive alternative, including other Government alternatives, like VHA or even rural housing. Does anyone disagree with synchronizing the FHA program to those alternatives so we are not attracting all the worst loans, basically?

Mr. STEVENS. Senator, I think it is a—this is a challenging subject. I think all options should be considered. The challenge with this idea of implementing a risk share program—and FHA was authorized by Congress to attempt to pilot in risk sharing—is that the borrower base at the VA is a very unique, select demographic

borrower base, and it is a very small population of loans. And so as we have studied this, the question is: How do you implement—how do you provide FHA the resources to do the counterparty reviews that would be required, do the assessments of the servicers who are providing that first loss, what forms of first loss would be provided, do they have the expertise to manage that kind of risk, and does that ultimately actually increase cost or risk to the taxpayer by infusing them with that obligation? And I think the tradeoff here is do you get that kind of improvement? Because ultimately, just like with the VA program, Ginnie Mae guarantees 100 percent of that loss risk to the investor should the counterparty fail. And if we expanded this to the size and scope of FHA, I think we just need to consider to make certain that the tools and resources would be in place that they could manage it and actually not increase risk to the taxpayer as a net result of that kind of structure—again, comparing it to the VA unused capacity.

Senator VITTER. OK. Well, Mr. Stevens, let me ask this follow-up. Do you agree or not that the present situation and the present differences often push worse loans toward FHA?

Mr. STEVENS. Without question, if you look at the average credit score of the FHA portfolio and the average loan-to-value, it is an entirely different portfolio than what Freddie Mac and Fannie Mae have. And, likewise, their premium structure is very different. I do not want to gloss over the concern because I agree completely that the footprint is too large and needs to scale back. But if you just look at the 2010, 2011, and 2012 portfolio book years, after all the new premiums have been put in place and with the current credit criteria, the 2012 portfolio is expected to produce just under $12 billion in profits back to the taxpayer. All of the losses in the FHA Actuarial are from the book years of 2006 through early 2009 due to a lot of programs we have talked about previously, which are all eliminated.

If we can box in the credit criteria and limit the footprint to what it is supposed to be serving over time, you can have a program that functions under the current construct. It is just a matter of making certain that you do not allow adverse selection to occur at an extreme or underprice the premium risk for that same portfolio.

Senator VITTER. A final question, because I am out of time. In terms of the mission and the footprint, does anyone here think—I know there is disagreement about the rate of pullback, et cetera. But does anyone think FHA should be insuring, you know, an almost $730,000 loan of a family earning $175,000?

Mr. THOMAS. It depends. It depends on when it is done. If it is done in a period like we have just experienced, I think it is something that should be done. If we were back to normal times when the private capital is in there, no, it should not. So I think it is performing exactly as it was supposed to, and those loans are performing extremely well.

Senator VITTER. Mr. Chairman, just to close, one last comment. My concern, Mr. Thomas, is between the huge growth in regulation of private industry and the huge growth in the footprint and the market share of FHA. I think those things are an impediment to ever getting back to “normal times.” And I am very concerned about permanently changing the landscape.

Mr. THOMAS. Yes, we do not think it should be permanently changed. We agree with you.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman, and thank you all for being here.

I want to pick up on Senator Vitter's point. You know, he is obviously making the point here that FHA is not the only large actor in the mortgage marketplace. It is not the only one with a taxpayer backup. And it is not the only one that currently threatens the taxpayers.

We have got Fannie and Freddie out there that are creating a huge problem, and I think we have alluded at various points and the Chairman raised a question about the deep interaction between FHA, Fannie and Freddie, and to some extent the VA and how these move together.

So when we think about underwriting standards, when we think about insurance pricing, for example, that you raised earlier, indemnification rules, risk mitigation rules, I am concerned—I understand the urgency of stabilizing the FHA, but I am concerned about approaching reforms in one without approaching reforms in the other.

So the question I would like to put before you is to ask you to speak to this interaction, which you have already raised, Dr. Swagel, I think, and whether it makes any sense to talk about reforming one if we are not reforming the other one simultaneously, and the extent to which we should talk about synching them. And synching them does not always mean they are the same. It just means they were written with each other in mind in terms of when one would take over and when the other would take over.

So I thought I would start with you, Dr. Swagel, but I am going to ask everyone to have a chance to comment on this.

Mr. SWAGEL. Absolutely. It is an important point that changes——

Senator WARREN. Hit your button.

Mr. SWAGEL. OK.—changes in one will affect the other. I would start by saying the GSEs have cost taxpayers a lot of money. The CBO now accounts for their risk properly. They use the fair-value accounting. As to FHA, that is the laggard. So that is something that can be done immediately. Again, it is not to say that FHA is any less important, but just to say let us take into account the risks there properly.

You know, I think the solvency and the mission really go together. I do not think you can say, well, let us just fix the solvency of FHA and not worry about the mission, because, you know, the high loan level—the high-value loans, if the FHA is underpricing its insurance, well, that is not profits. That is more risk. And so, I mean, it is almost like, you know, a Woody Allen joke that they are going to make it up by doing more of it, but they are losing money on each one.

So I think you really have to move forward urgently with FHA reforms, and I agree you want to do everything, but I think we all understand GSE reform is kind of often the future. And I just would not wait for that to happen.

Senator WARREN. But what does it mean to reform FHA if you are not going to reform Fannie and Freddie at the same time when you have just talked about how one bleeds directly into the other? I think the balloon analogy was the one you used, Mr. Stevens.

Mr. STEVENS. That is right, Senator. We believe that there needs to be reform of all three, and they have to be done in concert with each other. As a matter of fact, we have called even further. One of the unique variables of Freddie Mac and Fannie Mae is their regulator and the GSEs can make policy changes without going through the same process that FHA has to go through in the way that they inform the public and have a chance to discuss. And so actions taken sometimes by Freddie Mac and Fannie Mae suddenly produce volume increases to FHA that they did not even a chance to consider in concert.

So we have actually made a call in the short run that we think the Administration should appoint somebody to try to get the regulators to work together even on short-term policy actions to make certain that one move does not ultimately create an arbitrary bubble on the other side of the scale. And I agree completely that they should be done in concert. My only point was that as long as FHA is sort of the proverbial elephant in the room, until we get it on the right path that everybody agrees, it is kind of difficult to bring that into scope, talking about the overall construct.

Senator WARREN. Although I would say, Mr. Stevens, any room that has Fannie and Freddie in it describing anyone else as the elephant, a little tough——

[Laughter.]

Mr. STEVENS. I appreciate that.

Ms. BAZEMORE. If I could just add?

Senator WARREN. Please.

Ms. BAZEMORE. I think one of the things that we do have to keep in mind is one of the differences between FHA and Fannie and Freddie, while Fannie and Freddie may be in conservatorship, they do on their low downpayment loans have private capital in front of them in the form of private MI. I think sometimes that gets lost in the conversation. And so I think that is one thing.

I think there are also things that have already taken place that have helped sort of push borrowers toward FHA, and we spend a lot of time training and helping to educate lenders on the many times when the borrower would actually be better off with a privately insured loan than an FHA loan. And that has been sort of an education experience.

Senator WARREN. I see. Thank you.

Ms. Wartell.

Ms. WARTELL. Senator, I think your insight that these two are related is absolutely right, and let me make clear exactly why that is true. FHA is a 100-percent insurance product, and there is private capital not only in the form of MI, but one would hope if there is some successor to the Fannie and Freddie system in the future, the Government, if it plays a role, will play a limited backstop standing behind a whole lot of other private capital ahead of it. This is one place where Phil and I absolutely agree. And you want to ensure that as much of the market as possible in times that are

good are in places where private capital is well ahead of the Government.

So to constrain FHA's box without figuring out how much private capital you can get ahead of the Government on the other side is going to leave some places either—some loans to fall through the cracks or will inevitably delay the date when we can get sort of reasonable reform of the GSEs.

That said, a number of us have talked about things that need to get fixed now that are either in statute or regulation that everybody knows we need to fix, and I do not believe the political consensus on the GSEs is going to emerge imminently, and so if not, let us get the low-hanging fruit done.

Senator WARREN. But we have got to keep pushing.

Ms. WARTELL. We have got to keep pushing.

Senator WARREN. All right. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thanks very much. Thank you, Mr. Chairman. Thanks for holding this hearing, and I also want to commend you and Ranking Member Crapo for your interest in doing some FHA reform.

I am not of the opinion that we have to wait until we have the perfect solution for every possible entity. That day may never come. We know we have got problems. We have asymmetries in various features that have market-distorting effects already. There certainly are things we could do for FHA, in my view, even if we cannot do some of the other things that are also necessary eventually with Fannie and Freddie.

I also want to just make a quick editorial comment before I ask a couple of questions, which is I just want to suggest that we consider on a sort of macro level. Until very recently, when the Fed adopted an extraordinary policy, we have had essentially privately financed Government debt markets. We have private capital that finances the biggest commercial paper market in the world. We have private capital that finances the biggest corporate bond market in the world. We have the biggest equity markets in the world that are principally financed by private capital.

Private capital can finance the residential mortgage industry in America. It absolutely can. And the reason it does not now is because Government entities systematically misprice the risk, squeeze the private sector out, and if anyone doubts that, I think the massive losses that we have seen in the Government entities is the clear evidence of the mispricing of the risk.

So I think that—we cannot do this overnight. I understand that. We have got to do it carefully and thoughtfully. But I just reject the notion that private markets are not capable of providing this financing.

I would like to follow up with Ms. Bazemore about some of the ideas that you included in your testimony, some of which I think make an awful lot of sense. One is the eligibility standards. Am I correct in understanding there is no income test, there is no upper income limit for allowing someone to qualify for an FHA loan?

Ms. BAZEMORE. Right. My understanding is that it is based on the loan limits, and so ever since the Congress acted to make the

loan limits higher in 2008, essentially private capital in the form of MI has been competing with the FHA program.

Senator TOOMEY. So if you have got $1 million a year income and you buy a home for $500,000, you could qualify for an FHA gee?

Ms. BAZEMORE. That is my understanding. Is that right?

Senator TOOMEY. Or $5 million a year, it does not matter? That does not strike me as serving any purpose for low- and moderate-income folks to have no ceiling.

Ms. BAZEMORE. Well, I think that is why we suggested that maybe income was the way to approach this to make sure that the borrowers whom the program was intended to serve were, in fact, being served.

Senator TOOMEY. I think that is an obvious opportunity to look at.

Another question. You suggested that perhaps we would have reforms that would include reducing the FHA's guarantee below the 100-percent level. Could you elaborate on that? Do you have a specific level in mind, a reason why you think that is a good direction to move?

Ms. BAZEMORE. Well, we were recommending that it would be more in alignment with the way the VA program works, and I think you heard even from others that while the borrower base may be different, the VA loans have performed much better. And I think, you know, there has been a lot of discussion, too, about having sort of risk involved, and one of the things that we have found in terms of looking at going through this process is we were very focused on the counterparty risk that Mr. Stevens talked about, and we really started to understand how important the competency level of the lender was in terms of underwriting the loan. And so if the lender has some skin in the game in that regard, we believe that ups the level of underwriting.

Senator TOOMEY. Mr. Swagel, did you want to comment on this?

Mr. SWAGEL. I just agree that, you know, having the private capital—it just aligns incentives. It protects taxpayers and it gives the originator the incentive to be prudent.

Senator TOOMEY. Then my last question is for Ms. Bazemore. You have another point here where you suggest that we require the FHA to establish premiums that accurately reflect the true risk of the loans. The FHA currently has discretion, right, to some degree in where it establishes the premiums? And, generally speaking, is it true that the current levels are not at the maximum permissible level? Is that correct?

Ms. BAZEMORE. Correct.

Senator TOOMEY. Do you have any specific thoughts on what ought to be required here? How much higher, should we narrow the band of discretion? What are your thoughts on that?

Ms. BAZEMORE. No, I do not think I can speak to the exact level that it should be but, rather, taking the risk overall into account and then looking at it from an actuarial standpoint and determining sort of where the premium should be in terms of making sure the program is able to survive, flourish, and be able to pay its expenses without any cost to the Government.

Senator TOOMEY. Thank you very much, Mr. Chairman.

Chairman JOHNSON. Senator Manchin.

Senator MANCHIN. Thank you, Mr. Chairman. And I think all of you have heard that we have some concerns, and I come from the State of West Virginia, which we never really hit the housing bubble. We had pretty strict antipredatory laws. It was just good common sense. We thought you had to have a little skin in the game. You should be able to afford what you were buying, and we would make sure that happened.

With that being said, now we are holding the bag and paying for the mistakes that have been made. And the way FHA is expanding and putting more risk out there, we are even more at risk. So we are getting penalized for doing the right thing.

I would just ask all of you, would any of your run your business the way FHA has been run? If it was your money, would you be doing what we have done and allowed it to happen? I will start, Phillip, with you.

Mr. SWAGEL. No, to me that is the most worrisome thing, is that—the mission is the right one. We should just focus it. And, for example, the discussion of the FICO scores, I think the average FICO score is the right one, but that does not mean we have to have the extremes. People with very, very low FICO scores, they might not be ready to be homeowners, and——

Senator MANCHIN. In West Virginia, basically we always thought that FHA was there to help us get started. It was that first home buyer. It was in a smaller range to where the risk was not as great. But it got them a starter home, got them out there, and, you know, the value of the homeowner is everything. And now what I think I heard at the end there, Mr. Thomas, you are saying that you think they are doing the right thing by lending up to $700,000? That does not make any sense. I do not think that is FHA's role.

Mr. THOMAS. No, FHA's role was never to be just for first-time home buyers. That was not its initial role—even though most people have used it that way. I did. My first home was an FHA loan.

Senator MANCHIN. It was the entry market, right.

Mr. THOMAS. So I understand that. The problem is what we needed to have is some entity to make loans when nobody was there, and that is exactly what they have done.

The upper limit loans have not been a problem, you know, in the book of business. It has been performing extremely well.

Senator MANCHIN. Sure, when you have that type of income. I mean, it should be.

Mr. THOMAS. I understand. But if there was not somebody else there to make the loan——

Senator MANCHIN. You are basically saying for all the mistakes that we have made in the past, now we have to go back and really raid the private market——

Mr. THOMAS. No.

Senator MANCHIN. ——in order to basically prop up——

Mr. THOMAS. No, that is not what I am——

Senator MANCHIN. ——the shortfalls of FHA.

Mr. THOMAS. That is not what I am saying.

Senator MANCHIN. I am sorry, sir, but if you do not mind, I really—we will talk later. I would like to.

Mr. THOMAS. OK.

Senator MANCHIN. I want to make sure I get to Ms. Wartell, and then I will come right here.

Ms. WARTELL. Thank you, Senator. You make a point about how we run this, would we run a business like this, and I wanted to emphasize something. We subject FHA to the same rules of other regulatory programs when, in fact, it is a business. And so many of us have touched on the inability of FHA to act quickly to protect its business because there are rules and procedures in place for making changes that would give due process to the subjects of regulation. And yet this is a fundamentally different kind of governmental activity.

And so to your point, we need to make sure that FHA has the ability to change its risk profile to reduce its business practices and not require legislative change, there needs to be oversight, there needs to be parameters, there needs to be transparency. But give them the ability to act quickly to protect its taxpayers as you would want a business to do.

Senator MANCHIN. Let me just say this: In the 1940s, we were able to help the veterans returning from the war. In the 1950s, 1960s, and 1970s, we were helping the elderly, the handicapped, and lower-income Americans. And now we seem to be focused on the higher. That is what I was really getting to. And if we are doing that, we got away from the mission of helping the first-home, low- to middle-income?

Mr. THOMAS. Actually, the mission was to be there in times of stress and to serve the underserved, is really what it was.

Senator MANCHIN. Right.

Mr. THOMAS. At this point in time they were underserved. And, remember, it is only 2 percent of the book of business. It is not a huge amount of the business. So it is not like 50 percent of it is going to the upper limits. That is not the case.

Senator MANCHIN. Yes?

Ms. BAZEMORE. I would just say that, you know, our industry has continued to be involved in writing business throughout, and about a third of the business that we write is for first-time home buyers. But aside from that, I think this aspect of how you would run the business, this is about making sure that we are making sustainable and responsible home loans. At the end of the day, we have an alignment of interest with the borrower. You know, we are in a first-loss position behind the borrower, and we believe that how you run this should be to make sure those loans are sustainable and it is the right thing for the consumer and that it is the right thing for the company.

Senator MANCHIN. I would simply say this—and my time is up, but I would simply say that basically when somebody else's money is at risk, it seems like we have not learned from our past mistakes. And I would say to all of you, this is all of our money at risk. This is all of ours, and we should be concerned about how we have run this. And if we have not learned from our mistakes, we are never going to correct it. And I look forward to further questions.

Chairman JOHNSON. I would note that Senator Crapo has been called away to another meeting. He had some remaining questions, and they will be received.

I would like to thank all of the witnesses for being here with us today, and I look forward to working with Ranking Member Crapo to strengthen FHA.

This hearing is adjourned.

[Whereupon, at 11:34 a.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF GARY THOMAS

PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

FEBRUARY 28, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, and Members of the Committee; my name is Gary Thomas. I am a second generation real estate professional in Villa Park, California. I have been in the business for more than 35 years and have served the industry in countless roles. I currently serve as the 2013 President of the National Association of REALTORS® (NAR).

I am here to testify on behalf of the 1 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the importance of the Federal Housing Administration's (FHA) mortgage insurance program. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the Nation's housing stock and making it available to the widest range of potential American households. The Association has a long tradition of support for innovative and effective Federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure Federal housing programs meet their missions responsibly and efficiently.

FHA is an insurance entity within the Department of Housing and Urban Development (HUD) that ensures that American homeowners have access to safe and stable financing in all markets. FHA has insured home loans for more than 37 million American families since its inception in 1934 and has never required a Federal bailout. While many so-called experts have questioned the program's recent performance, NAR would argue that FHA has demonstrated its considerable importance during the significant housing and economic crisis our country is still experiencing.

History of FHA

When FHA was created by the 1934 National Housing Act, the primary goal of the Administration was to insure loans for home improvements. [1] In the wake of the Great Depression, the Nation's housing stock was crumbling. Houses were not being maintained or modernized and the result was a negative feedback loop of deteriorating living conditions and falling home prices. At the same time, painters, carpenters, landscapers, workers in the dozens of trades involved in making home improvements were without work. By creating an agency to insure small, private capital loans for home improvements, the Federal Government hoped to address these issues simultaneously.

While home improvement loans were the first listed aim of the National Housing Act of 1934 and the subject of the Act's first Title, the full scope of the law went further. According to the Report of the House Committee, the intent of the National Housing Act of 1934 was:

> to improve Nationwide housing standards, provide employment, and stimulate industry; to improve conditions with respect to home mortgage financing, to prevent speculative excess in new-mortgage investment, and to eliminate the necessity for costly second-mortgage financing, by creating a system of mutual mortgage insurance and by making provision for the organization of additional institutions to handle home financing . . . [2]

These goals were achieved not through small loans for home improvements, but through what would become the Act's more enduring legacy: mutual mortgage insurance. Authorized by Title II of the National Housing Act, FHA's mutual mortgage insurance sought to insure loans up to $16,000 for the purchase of new and existing homes and spread the loan amortization period over a 20-year period. Up to this point, most home loans were balloon loans that had to be refinanced every few years, subjecting consumers and the market to massive volatility. By spreading out the amortization, the Government hoped to make the market more stable, and create predictability for both homeowners and the financial industry. [3]

A common misconception exists that FHA was originally intended to benefit low-income borrowers who could not afford a large downpayment on a new home. While an upper limit of $16,000 for a home loan may seem exceptionally small today, in

[1] 13 Wayne, L.R. 651, 652 (1967).

[2] H.R. Rep. No. 1922, 73d Cong., 2d Sess. 1 (1934).

[3] "First Annual Report of the Federal Housing Administration for the Year Ending December 31, 1934", U.S. Government Printing Office. 1935. P. 4

1930, the national median home value was $4,778.[4] Only 3.2 percent of homes were valued between $15,000 and $20,000.[5] The majority of homes were valued between $2,000 and $7,500, with the largest number between $3,000 and $5,000.[6] So an upper limit of $16,000 in 1934 was more than 300 times the value of the median American home at that time.

Of course, a $16,000 loan limit does not paint the entire picture of FHA's target demographic. To better understand this, we should look at how the program was used by borrowers. In its third annual report to Congress in 1936, FHA's statistics showed that most of the homes insured were valued in the $3,000 to $6,000 range and the average single-family home value for an insured mortgage was $5,497, more or less reflecting the average costs of homes at the time.[7] Only 2.8 percent of FHA-insured homes were valued below $2,000, and only 2.1 percent above $15,000.[8] This is strong evidence that FHA was not originally targeted to any income group, but rather to help families across the income spectrum get financing to purchase homes. These statistics varied slightly from year to year, with the size of insured mortgages somewhat lower in 1937 (median $4,288), and then higher in 1938 (median $4,491).[9] [10] In general, these percentages have mirrored the distribution of incomes of FHA-insured borrowers.[11] [12] A study on FHA recently reported that "The Section 203(b) program was clearly intended to deal with the vast bulk of the home ownership market, excepting only the wealthiest few.Thus initially, FHA was narrowly targeted to the promotion of single-family home ownership but broadly targeted to all but the lowest and highest income markets."[13]

In a similar vein, the original loan-to-value ratio (LTV) limit for FHA mutual mortgage insurance was set at 80 percent. This sounds like a high downpayment requirement today, but it was considerably less than what lenders had previously required. Home loans prior to FHA had downpayment requirements as high as half the value of the home, and as a result the American home ownership rate in 1930 was below 50 percent.[14] Because FHA-insured loans were amortizing and thus inherently less risky for both borrower and lender, a lower downpayment requirement was justifiable. When the last payment on the loan was made, the loan was paid off. These changes proved very popular: nearly 60 percent of FHA-insured borrowers in 1937 had LTVs between 76 and 80 percent, a jump from 47 percent in the preceding year.[15] Indeed, the loosening of the downpayment requirement proved successful enough for FHA to raise the loan to value ratio again in 1938 to 90 percent for some loans.

Over the next few decades, FHA continued to update a number of its core policies. In 1934, the loan term for FHA-insured loans was 20 years. By 1954, FHA had changed its loan term to 30 years, a term that is still in place today. While the original downpayment for FHA loans was 20 percent, it was lowered to 5 percent by 1950 and to 3 percent in 1961. This downpayment stayed in place for 47 years, until Congress increased it to 3.5 percent in 2008.

Role of FHA During the Recent Housing Crisis

FHA has sustained housing markets nationwide during the worst economic crisis of our lifetime. As private lenders fled and financial institutions went out of business, FHA remained in the market and has provided insurance to more than 4 million families since 2008. In a time when many of the large private banks, investment firms, and other financial institutions have needed bailouts or have even col-

[4] Id. at 18.

[5] "15th Census of the United States, Population, Volume VI: Families", U.S. Census Bureau, 1930, P. 17.

[6] Id.

[7] "Third Annual Report of the Federal Housing Administration for the Year Ending December 31, 1936", U.S. Government Printing Office. 1937. P. 35.

[8] Id.

[9] "Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937", U.S. Government Printing Office. 1938. P. 58.

[10] "Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938", U.S. Government Printing Office. 1939. P. 85.

[11] "Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937", U.S. Government Printing Office. 1938. P. 61.

[12] "Fifth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1938", U.S. Government Printing Office. 1939. P. 91.

[13] Vandell, Kerry D., "FHA Restructuring Proposals: Alternatives and Implications", Housing Policy Debate, Volume 6, Issue 2, Fannie Mae, 1995.

[14] "15th Census of the United States, Population, Volume VI: Families", U.S. Census Bureau, 1930. P. 12.

[15] "Fourth Annual Report of the Federal Housing Administration for the Year Ending December 31, 1937". U.S. Government Printing Office. 1938. P. 60.

lapsed, FHA has weathered the storm very well. FHA continues to have significant resources to pay 30 years' worth of expected claims on its portfolio, an amount 30 times more than that required of banks, which are only required by the Financial Accounting Standards Board (FASB) to hold 1 year of reserves. In addition, FHA continues to have additional reserves in the MMI Fund of more than $2.5 billion. This is truly an achievement; FHA should be lauded for its financial stability in a most challenging environment and held up as a standard for strong underwriting and risk avoidance.

This recent period is not the first time FHA has played a countercyclical role. The FHA helped stabilize falling home prices and made it possible for potential homebuyers to get the financing they needed when recession prompted private mortgage insurers to pull out of oil producing States in the 1980s. According to FHA Commissioner Shaun Donovan, "FHA picked up private market slack in Texas, Oklahoma, and Louisiana during the Oil Patch bust in the late 1980s and in Southern California during the early 1990s, and it is playing this role again today." [16] Between 1986 and 1990, FHA's market share increased dramatically, as private lending tightened up or left. A GAO report said of the time, "private mortgage insurance (PMI) companies change the conditions under which they will provide new insurance in a particular geographic area to reflect the increased risk of loss in an area experiencing economic hardship. By tightening up the terms of the insurance they would provide, PMIs may have decreased its share of the market in economically stressed regions of the country." [17] However, FHA continued to provide insurance to these areas, stabilizing housing prices.

As private lending constricted (and in some markets, disappeared altogether), FHA's role in the market grew. As recently as 2006, FHA's share of the home mortgage market was down to 3 percent, as unscrupulous lenders lured FHA's traditional constituent to risky exotic mortgages with teaser rates and little to no underwriting criteria. As the housing market began to collapse, private lenders fled or went out of business. As is seen in Figure 1, [18] FHA's share of the market began to grow, as the private market's share plummeted. This demonstrates the countercyclical role FHA plays in the market.

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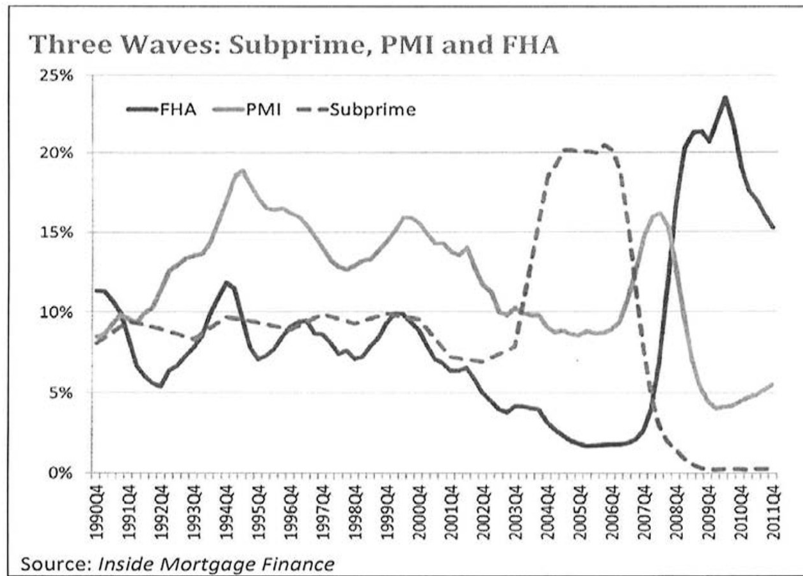
[16] Written Statement of Secretary Shaun Donovan U.S. Department of Housing and Urban Development Hearing before the Subcommittee on Transportation, Housing, and Urban Development, and Related Agencies Committee on Appropriations United States Senate, "The Role of the Federal Housing Administration (FHA) in Addressing the Housing Crisis", Thursday, April 2, 2009.

[17] GAO, "FHA's Role in Helping People Obtain Home Mortgages", August 1996, GAO/RCED-96-123.

[18] Quercia, Roberto G., and Park, Kevin A., "Sustaining and Expanding the Market: The Public Purpose of the Federal Housing Administration", UNC Center for Community Capital, December 2012.

Figure 1



Source: *Inside Mortgage Finance*

Mark Zandi of Moody's Analytics has pointed out that "If FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it." [19] Moody's has estimated that without FHA, housing prices would have dropped an additional 25 percent, and American families would have lost more than $3 trillion of home wealth.

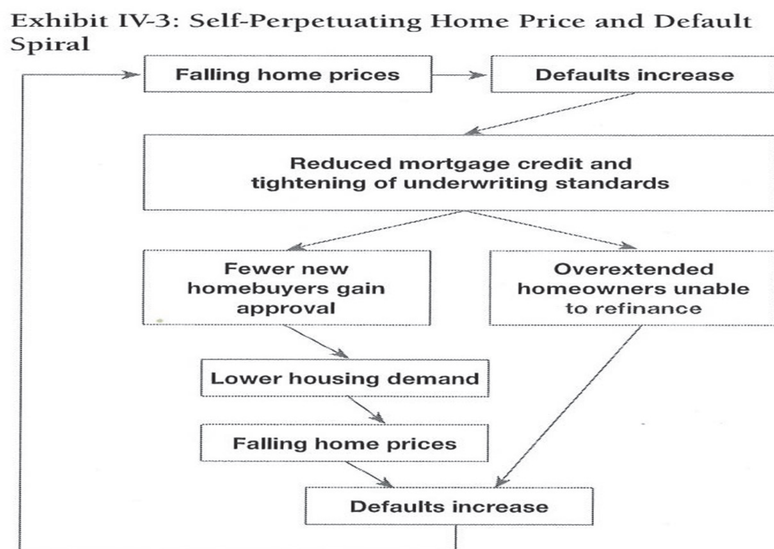
Instead, FHA continued to lend. From 2007–2009, FHA helped more than 1.8 million Americans become homeowners. Even more importantly, FHA helped stabilize housing prices in thousands of communities by providing access to home financing when few others would. A recent University of North Carolina study noted that "Private mortgage insurers implemented 'distressed area' policies making it almost impossible to obtain conventional mortgages with LTV ratios greater than 90 percent in some regions of the country. In contrast, FHA does not vary its insurance premiums by region, creating an automatic regional stabilization policy." [20] This countercyclical role of FHA helped stabilize markets and slowed the downward spiral of housing prices and economic decline (*see,* Figure 2 [21]).

[19] Zandi, Mark, "Obama Policies Ended Housing Free Fall", *The Washington Post*, September 28, 2012.

[20] Quercia, Roberto G., and Park, Kevin A., "Sustaining and Expanding the Market: The Public Purpose of the Federal Housing Administration", UNC Center for Community Capital, December 2012.

[21] Szymanoski, Edward, William Reeder, Padmasini Raman, and John Comeau, "The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market", PD&R Working Paper No. HF-019, December 2012.

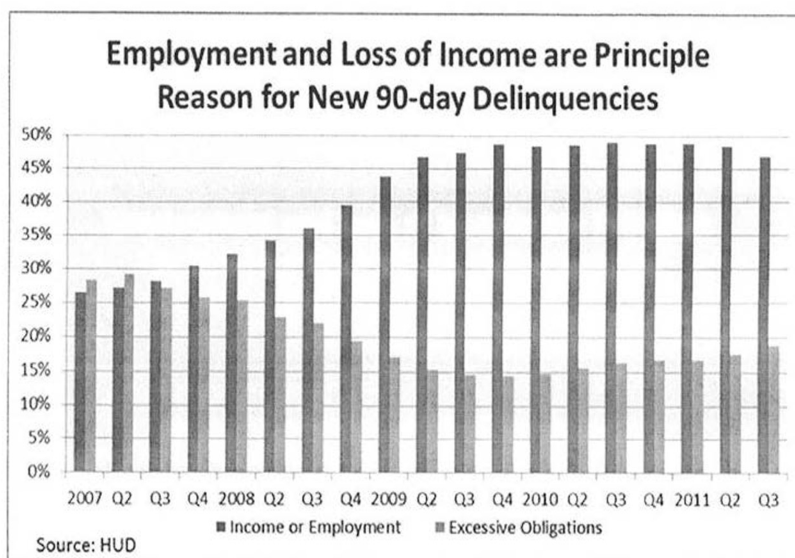
Figure 2



Had FHA not stepped in and filled this mortgage insurance void, many neighborhoods would have been devastated and our economy will still be in a recession.

Some have criticized FHA for the high foreclosure rate on loans it insured during the period of the crisis. It is true that these loans have had a serious impact on the health of the Mutual Mortgage Insurance Fund (MMIF). More than $70 billion in claims that FHA has filed can be attributed to the books of business made in 2007–2009. Housing prices continued to decline through 2009. Lending in declining markets raises risk. FHA and private insurance and lenders that remained during that time period were all impacted. This was not a result of lax underwriting or inappropriate lending. FHA's most recent survey of the drivers of default showed that for the past 4 years, the overwhelming reason for delinquency has been reduced employment and reduced income—accounting for nearly 50 percent of all delinquencies for the past 10 quarters (*see,* Figure 3).

Figure 3



No one can be expected to predict the job loss and other fallout a household may suffer from a recession. Federal Reserve Chairman Ben Bernanke has said that, "an increasing share of losses have arisen from prime mortgages that were originally fully documented with significant downpayments, but have defaulted due to the weak economy and housing markets." [22] In 2009, even the Congressional Research Service cleared FHA from blame noting, "FHA would not be able to prevent defaults arising from deteriorating financial and macroeconomic conditions." [23] Home prices have fallen 33 percent since 2006, causing much of FHA's financial decline. On a very basic level, the actuarial report analyzes the value of FHA's outstanding mortgages as compared to the value of the homes. As housing prices have fallen, so has the value of FHA's books. As a participant in the home mortgage process, FHA cannot be immune to the pitfalls of the housing crisis. Solid underwriting policies and safe lending practices have protected it from the biggest failures.

FHA Today

Loans insured by FHA require full documentation of income and assets. During the height of the real estate bubble, FHA was marginalized while exotic mortgages such as stated-income loans and payment option adjustable rate mortgages became common practice. When the bubble burst, these subprime and often predatory loans were prohibited by the regulators, leaving the industry searching for a stable mortgage product. Lenders using FHA must examine an applicant's financial status including income, debts and obligations. Generally, the monthly mortgage payment may not exceed 31 percent of a borrower's gross income and 43 percent of all debt payments. [24] Borrowers are required to have a 3.5 percent downpayment and closing costs may not be considered part of this financial contribution.

Recognizing the impact foreclosure has on communities and homeowners, FHA offers several programs to minimize risk to the MMIF and help families facing financial hardship stay in their homes. FHA may offer a loan modification, special forbearance, a partial claim, or foreclose on the property. Loss mitigation programs are available for both forward and reverse mortgages insured by FHA. Payments by FHA to a lender through loss mitigation do not impact taxpayers or the Federal budget because they are derived from insurance payments made by FHA borrowers.

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[22] Speech by Federal Reserve Chairman Ben Bernanke at the at the 2012 National Association of Homebuilders International Builders' Show, Orlando, Florida, February 10, 2012.

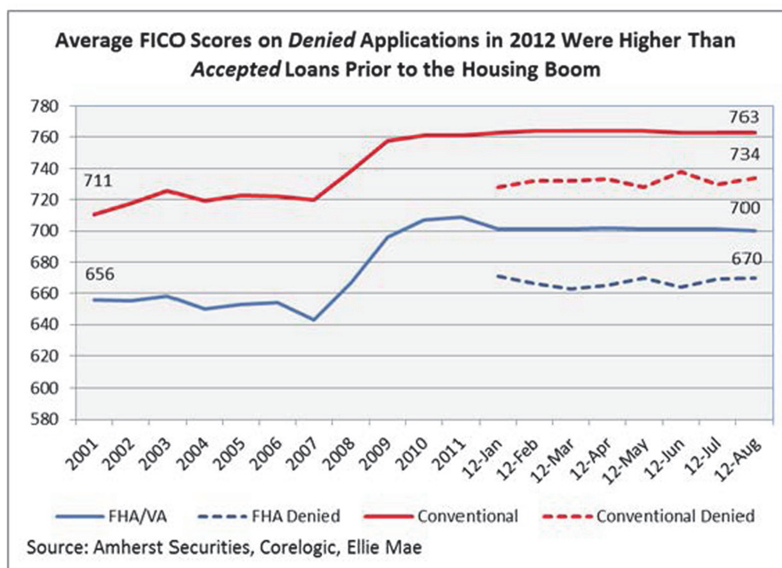
[23] CRS Report R40937, "The Federal Housing Administration (FHA) and Risky Lending", coordinated by Darryl E. Getter.

[24] HUD 4155.1 4.F.2.B and HUD 4155.1 4.F.2.C.

FHA continues to play a significant role for first-time buyers and minorities. In 2012, 78 percent of the 700,000 purchase loans FHA insured were for first-time buyers. Since 2009, FHA has insured mortgages for more than 2.8 million first-time buyers. Were it not for FHA, these buyers would not be homeowners, and 2.8 million homes would still be on the market. This would have been devastating on our Nation's economy. Half of African American homebuyers and nearly the same percentage of Hispanic and Latino buyers who purchased in 2011 used FHA financing. Even in 2001, before the crisis, more than twice as many minority first-time buyers used FHA than a loan that was guaranteed by Freddie Mac or Fannie Mae.

Since the crisis, the quality of FHA borrowers has skyrocketed. The average FICO score of an FHA borrower in 2012 was 699. The average FICO score on denied FHA applications was 670. Less than 4 percent of all FHA borrowers in the first half of 2012 had credit scores below 620. Figure 4 illustrates that FHA's denials in 2012 are higher than loans accepted in prior years. This figure also demonstrates that private lending has constricted to the degree that borrowers with credit scores over 730 are now being denied access to conventional credit. This draws more borrowers to FHA.

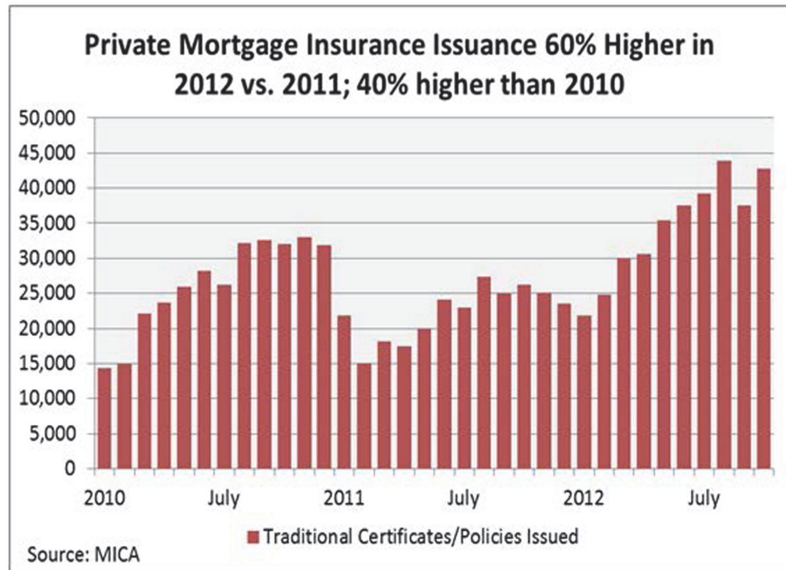
Figure 4



Some have criticized FHA for lending to borrowers with such high credit scores. But if they are denied a loan in the private marketplace, where else can they turn? That is exactly FHA's role—to lend to the underserved. As hard as it is to believe, borrowers with credit scores below 760 may be underserved by the private market.

The private market is returning, albeit slowly. As Figure 1 demonstrated, FHA's market share is declining, as private lending tentatively reenters the marketplace. PMI's business has increased by 60 percent over where it was in 2011, but only 40 percent higher than in 2010 (Figure 5).

Figure 5



While economic conditions have limited private market participation, the regulatory and oversight landscape also has made lenders very wary of making home loans. Upfront charges for loans financed by the GSEs (called loan level pricing adjustments) and representation and warranty risks are significant factors. While lenders received clarity on new origination standards with the release of the qualified mortgage rule (QM) in January; fundamental changes to the structure of the secondary mortgage market are necessary before the role of the private market can be fully restored. Both the Government and private sector issue mortgage-backed securities (MBS), which are bundles of mortgages sold to investors. Investors in privately issued mortgage backed securities (PLS) experienced severe losses during the housing bust and questions have been raised about the quality of loans in the securities. As a result, since the housing downturn investors have favored MBS backed by Ginnie Mae, Fannie Mae, or Freddie Mac because of the Government guarantee and stronger underwriting and transparency. This need to restore investor confidence is critical to strengthen the private sector.

There has been much said about FHA's market share. To clarify, 15.8 percent of all people who purchase a home use FHA-insured financing. In recent years, the number of people paying cash for a home has increased. So when looking at all the people who use a mortgage to purchase a home, 26 percent of those buyers use FHA-insured financing. Most private lenders today require a 20 percent downpayment. For those who allow a smaller downpayment along with some kind of mortgage insurance, 44.6 percent of those loans are FHA-insured.

The National Association of REALTORS® welcomes a return of a robust private market. But we are not there yet. One needs only to look to markets not well-served by FHA—such as loans above $729,750 or the condominium market. Credit in those markets is very tight, requires significant cash downpayments, or is simply unattainable. We strongly caution against actions to precipitously lower FHA's share of the market. We believe such changes at this time will simply lower the overall pool of mortgage credit available—keeping more creditworthy borrowers from being able to own a home of their own. When regulatory uncertainty is resolved, and there is a known future of secondary mortgage credit, private lenders will return.

Mutual Mortgage Insurance Fund (MMIF)

It is likely that FHA will need to borrow money from the Treasury this year, but it is important to look at why. FHA did not offer risky mortgage products. FHA did not engage in exotic underwriting. FHA did not have accounting problems or other unscrupulous behavior. Instead, FHA stepped in during our housing crisis, and pro-

vided access to mortgage credit to millions of responsible Americans who wanted to purchase homes. Many of the mortgages FHA entered into during the crisis were in declining markets. Lending in declining markets increases risk. However, had FHA not stepped in to fill that market void, our economy would still be far from recovered.

Although the Federal Credit Reform Act (FCRA) and FHA's 2 percent capitalization ratio may require FHA to borrow from the Treasury, that money will not actually be spent to pay claims. The actuarial study predicts that FHA has sufficient resources to pay 7–10 years' worth of claims right now—with no future business. But the Treasury draw may be necessary to hold a reserve able to fully fund all claims over a 30-year period. So FHA will simply be holding this money in reserve. This is money that the actuarial report says will be unnecessary by FY2014, when the FHA fund will return to self-sufficiency. Some have argued that such a requirement is a misuse of taxpayer money, when it is not needed to pay debts.

Another factor that has had a significant negative impact on FHA's losses is the use of seller-funded downpayment assistance. Downpayment assistance from the seller was never permitted by FHA, but in the 1990s, some organizations formed schemes to circumvent the widely accepted prohibition on seller-provided downpayments by forming middle-man "charitable" organizations that funneled seller monies through to the buyer. As early as 1999, FHA proposed eliminating these loans. But FHA was unable to do so because of successful litigation to prohibit the ban. Finally, in 2008, FHA received legislative relief to prohibit these loans. However, the damage had been done. These loans reached a record default rate of 28 percent, and account for more than $15 billion of FHA's current deficit.

Looking forward, the more recent books of business are of the highest quality in FHA history. The projected performance of the recent books of business (FY10–FY12) has improved steadily in the last three audits. Even the FY12 Actuarial Review shows FHA will be fully capitalized again in FY2014, and will reach the desired 2 percent capital reserves ratio by 2017, which is above and beyond the required 30-years' worth of reserves.

Response From FHA

Over the past 4 years, FHA has made many administrative changes to mitigate risk. FHA has increased mortgage insurance premiums (MIP), hired the agency's first Credit Risk Officer, implemented a credit score floor, required a greater downpayment for borrowers with lower credit scores, and adopted a series of measures to increase lender responsibility and enforcement.

FHA has increased its premiums five times in the last 4 years, to a now historic high level. Beginning on April 1, 2013, the annual premium for new mortgages less than or equal to $625,500 and LTVs greater than 95 percent will be 1.35 percent. The annual premium for new mortgages greater than $625,500 with LTVs greater than 95 percent will be 1.55 percent. FHA also removed the automatic cancellation of the annual MIP for fixed-rate mortgages with LTVs greater than 90 percent at origination. These borrowers will have to pay the annual MIP for the life of the loan beginning June 3, 2013. While these changes may be necessary in the short-term, we encourage FHA to reconsider the need for these charges, when mortgage markets stabilize and the FHA fund returns to full capitalization.

FHA has also instituted changes to low credit score borrowers. Borrowers with a credit score below 500 are not eligible for FHA-insured mortgage financing, and those borrowers with credit scores between 500 and 579 are required to make a 10 percent downpayment. FHA has also increased the downpayment (as well as imposed an additional premium increase) for borrowers with loans above $625,500 from 3.5 percent to 5 percent. NAR strongly opposes this increase, as the actuarial report has repeatedly shown that the higher limit loans perform better than the rest of the portfolio, and thus are helping the financial standing of the FHA fund.

NAR Recommendations

NAR advocates for some additional changes to FHA with respect to condominiums, to ensure its continued strength and availability to homeowners.

Condominiums are often the only affordable option for first time home buyers. FHA updated the condominium rules in September of 2012, but we recommend additional changes that will provide greater liquidity to this sector of the real estate market without causing additional risk to the MMIF. We support enhancements to the rules and limits relating to owner-occupancy, investor ownership, and delinquent homeowner association (HOA) assessments.

NAR recommends elimination of the owner-occupancy ratio requirement for FHA condo mortgages. The GSEs do not have an occupancy ratio for condominium projects if the borrower is going to occupy the unit, which is the case for all FHA

borrowers. Eliminating this requirement will allow more households looking for a principal residence to purchase condominiums, which are often more affordable, raise occupancy levels, and stabilize these developments and their communities.

FHA should continue to provide additional flexibility on condominium recertification requirements and fidelity insurance coverage requirements. The existing rules place significant data and liability burdens on often-volunteer boards of condominium and homeowners associations and limit the stock of housing units available to FHA buyers.

Conclusion

The National Association of REALTORS® strongly believes in the importance of the FHA mortgage insurance program and believes FHA has shown tremendous leadership and strength during the recent crisis. Due to solid underwriting requirements and responsible lending practices, FHA has avoided the brunt of defaults and foreclosures facing the private mortgage lending industry. We applaud FHA for continuing to serve the needs of hardworking American families who wish to purchase a home; and we stand in support of its mission, its purpose, and its performance, particularly in times of a national housing crisis.

PREPARED STATEMENT OF PETER H. BELL

President and Chief Executive Officer, National Reverse Mortgage Lenders Association

February 28, 2013

Mr. Chairman and Members of the Committee: Thank you for convening this hearing to look into the Federal Housing Administration's (FHA's) Financial Condition and Program Challenges. I am here today in my capacity as President and CEO of the National Reverse Mortgage Lenders Association (NRMLA), a trade association of over 300 companies involved in the origination, funding and servicing of reverse mortgages. Our organization has been serving the reverse mortgage industry as a policy advocate and educational resource since 1997. We also provide information about reverse mortgages to consumers and members of the press.

NRMLA member companies are responsible for over 90 percent of the reverse mortgages made in the United States. All NRMLA member companies commit themselves to our Code of Ethics & Professional Responsibility. Under that Code, placing the needs of the client takes precedence over all other considerations.

This Committee, including members from both sides of the aisle, has been consistently sensitive to reverse mortgage issues and has continually taken steps to improve and enhance FHA's Home Equity Conversion Mortgage (HECM) program. For that, we are very appreciative, as are the three-quarters of a million senior households who have utilized the HECM program since its inception.

The issues surrounding reverse mortgages bring a key question into consideration: How do we finance our longevity?

There were 4.2 million Americans over 85 years old in 2000; there will be over 9 million Americans over 85 years old in 2030. With life carrying on for decades beyond our earning years, we must manage assets and resources to sustain ourselves longer. Aging in place, remaining in one's own home for the duration of life or as long as physically possible, is simply the most cost-effective and financially sensible housing option for many. This requires the strategic use of home equity as a means of financial support.

Housing wealth, the equity accumulated in a home, represents the largest component of personal wealth for many American households. Typical retiree households might have Social Security income, a modest pension, limited income from low-yielding fixed-income instruments, and, perhaps, a diminished 401(k) account. The equity they have built up in their home is often their greatest asset, an important resource for funding their future.

The Bi-Partisan Policy Commission, in a report issued earlier this week, cited that half of homeowners 62 years of age or older had at least 55 percent of their net worth tied up in home equity. Furthermore, according to the Commission report, 9.5 million households headed by someone age 65 or older, spend more than 30 percent of their income for housing expenses, including mortgage payments; 5.1 million spend more than half their income on housing.

Congress recognized this when initially authorizing the HECM program as part of the Housing & Community Development Act of 1987.

Before moving on to a discussion of current issues impacting the HECM program, I would like to provide an overview of the program's history. The history is important because it illustrates that HUD has acted responsibly in its role of stewardship

for this program. Furthermore, the Department has led a collaborative effort among all stakeholders—including the Government, senior advocates, social service providers, housing counselors and the reverse mortgage industry—to continually reevaluate and make modifications to this valuable program.

As a result, the HECM program has been able to serve over 750,000 homeowners since its inception. At the present time, there are approximately 578,000 senior households utilizing HECMs to help meet their financial needs.

A Brief History of the HECM Program

The development and implementation of the Home Equity Conversion Mortgage program was a deliberate and thoughtful process.

The first reverse mortgage loan in the U.S. was made in 1961 by Deering Savings & Loan in Portland, Maine, to a widow named Nellie Young. Over the next 20 years, various studies and surveys were conducted to explore the viability of such a product, most notably those by Yung-Ping Chen of UCLA and Jack Guttentag of The Wharton School and largely driven by Ken Scholen, then working with the Wisconsin Board on Aging, who wrote three books on the subject.

In 1980, Scholen presented the concept to the Federal Government and received funding from the Administration on Aging for a Home Equity Conversion project. The following year, the White House Conference on Aging, attended by leaders of organizations serving the senior sector, endorsed the creation of a Federal Housing Administration mortgage insurance program for reverse mortgage loans. It was another 9 years before the first FHA-insured reverse mortgage was issued. During this time more studies and hearings on the viability and need for such a program continued both in Washington and in many States.

In 1983, the Senate approved a proposal by Senator John Heinz for the creation of FHA insurance for reverse mortgages and a Senate/House conference committee called for a Department of Housing and Urban Development study of the idea. In 1985, HUD held a conference on the subject, but when they issued their study in 1986, the Department opposed a Federal reverse mortgage demonstration program. The following year, AARP offered a critique of HUD's decision, written by Scholen, and the 100th Congress passed the Housing and Community Development Act, directing the HUD Secretary to conduct a demonstration program for insuring reverse mortgages.

The National Housing Act of 1987, Section 255, outlined the specifics of the demonstration program. The purpose of the program was "to meet the special needs of elderly homeowners by reducing the effect of the economic hardship caused by increasing costs of meeting health, housing and subsistence needs at a time of reduced income, through insurance of home equity conversion mortgages to permit the conversion of a portion of accumulated home equity into liquid assets." Among the requirements contained in the original statute were:

- Adequate 3rd party counseling including explaining alternative financial options;
- A fixed or variable interest rate or future sharing between the mortgagor and the mortgagee of the appreciation in value of the property, as agreed upon by the mortgagor and the mortgagee;
- A list of disclosures to be delivered at least 10 days before closing;
- A guarantee to borrowers that they would be protected against disappearance of their lender and obligations beyond the value of their home at sale;
- Scheduled reports to Congress.

To create the new product, HUD created a development team under the auspices of Judith May. The team was led by Ed Szymanoski, a mathematician and economist, who managed the annual actuarial review of HUD's home mortgage insurance fund. They had no model to work from, so they built a simulation model to analyze the actuarial risks the FHA insurance fund would be exposed to under various scenarios. As Szymanoski later explained, "Innovations from our initial design recommendations included the first-ever two-part premium structure for an FHA program (two percent up front and 50 basis points annually), a two dimensional "principal limit" factor (by borrower age and interest rate) that is used as an effective limit on HECM LTVs (loan-to-value), and formulas for borrowers to set up their own customized payment plans—allowing maximum flexibility in choice among monthly payment streams, lines of credit or combination plans with both." All of this initial modeling remains a working part of the program today.

The pilot program was careful and initially limited to 2,500 loans through 1991. The first FHA-insured Home Equity Conversion Mortgage (HECM) was issued October 19, 1989, to Marjorie Mason of Fairway, Kansas. HUD selected 50 lenders to

make the first HECMs. The FHA sponsored fourteen 2-day counselor training sessions conducted by Scholen and Bronwyn Belling of AARP. In the first year (1990), 157 loans were closed. In the second year (1991), 389 loans were closed. The program grew slowly as it found its footing.

The original statute had called for evaluations of the program by HUD staff on a timely basis. The first report in 1992 was followed by further evaluation in 1995. Several subsequent evaluations have been conducted over the years.

The goals of the demonstration were to (1) permit the conversion of home equity into liquid assets to meet the special needs of elderly homeowners, (2) encourage and increase participation by the mortgage markets in converting home equity into liquid assets, and (3) determine the extent of demand for home equity conversions and types of home equity conversion mortgages that best serve the needs of elderly home owners.

The 1995 report stated "the Demonstration has made significant progress toward achieving each of these goals, although more time will be necessary to complete the work."

This report also addressed the adequacy of the mortgage insurance premium for the first time and concluded the present value of the premiums collected exceeded the value of insurance claim losses.

Once the program was launched, deliberation continued and it was closely observed. Over the subsequent years, Congress has amended the statute nine times, sometimes simply to clarify wording, others to alter substance. Changes include:

- In 1990, the volume cap was changed from 2,500 loans by the end of Fiscal Year (FY) 1991 to 25,000 loans by the end of FY1995;
- In 1996, the restriction on securing the loan with a single-family residence was changed to also include a 1-4 family residence in which the mortgagor occupies one of the units; the aggregate number of loans insured was changed twice from 25,000 through FY1995 to 30,000 through FY1996 and then to 50,000 through FY2000;
- In 1998, in the HUD Appropriations Act, the word "demonstration" program was struck and the program became permanent; the aggregate number of mortgages that could be insured was raised to 150,000;
- In 2000, refinance of existing HECMs was authorized and rules created for implementation including requiring a good faith estimate of costs and permitting a credit for previous upfront mortgage insurance premium against the new premium;
- In 2005, the volume cap was raised from 150,000 loans to 250,000 loans;
- In 2006, the volume cap was raised from 250,000 loans to 275,000 loans; in the Home Equity Act of 2006, regional loan limits for HECMs were eliminated and a single national loan limit equal to that of the Freddie Mac loan limit (then $417,000) was created;
- In 2008, via the Housing and Economic Recovery Act, limits were placed on origination fees; cross-selling of other financial products as a condition for obtaining a reverse mortgage was prohibited; rules assuring independence of counselors from lenders were strengthened; the establishment of qualification standards for counselors and a new counseling protocol was called for; HECM insurance was shifted from the General Insurance Fund to the Mutual Mortgage Insurance Fund (MMI); a provision to permit a waiver of upfront insurance premiums when proceeds are used to purchase a qualified long-term care insurance policy was eliminated; and the HECM for Purchase program, which authorized use of these funds for purchase of principal residences, was created;
- In 2009, as part of the American Relief and Recovery Act, loan limits were increased to 150 percent of the Freddie Mac limit or $625,500;

In addition to these legislative changes, HUD has also made periodic administrative changes to the program, including:

- In 2010, FHA reduced the Principal Limit Factors (essentially the Loan-to-Value ratio) for all HECMs by 10 percent to address concerns about the performance of the program and eliminate any need for credit subsidy;
- In 2011, FHA implemented an additional reduction in the Principal Limit Factors and raised the annual Mortgage Insurance Premium.

All in all, what occurred throughout the years has been a constant monitoring of the program by FHA and continual reevaluation both internally at HUD and by outside consultants, resulting in thoughtful steps being taken to manage the program proactively.

In 1997, just prior to the program being made permanent, the National Reverse Mortgage Lenders Association was formed. With new promise of a prolonged future, and perhaps partially due to the existence of an industry-wide professional organization, the business began to grow. In 2001, NRMLA had 32 member companies and about 7,800 loans were closed. By 2005, we had 370 members and over 43,000 loans were closed. By 2007, volume would surpass 100,000 loans per year, where it remained for 3 years. Current annual loan volume is about 60,000 loans.

In 2007, Ginnie Mae introduced its HECM Mortgage-Backed Securities program (HMBS). In November of that year, the first HMBS pool was offered by Goldman Sachs.

In Ed Szymanoski's last report on the demonstration program written in 2000, he reported a high level of satisfaction among HECM borrowers. In 2007, AARP reported that 93 percent of borrowers surveyed had a good experience with their loans. In 2010, consumer research conducted by Marttila Strategies for NRMLA reported that 90 percent of surveyed borrowers felt no pressure to proceed, 90 percent did not feel they were misled in any way or given wrong information, 80 percent said they were likely to recommend the product to a family member and more than 50 percent said they could not meet their monthly expenses without their HECM.

In 2012, in response to a Request for Information published in the Federal Register by the Consumer Financial Protection Bureau (CFPB), NRMLA retained ORC International (ORC), a widely respected independent consumer opinion research organization to survey a statistically significant sample of borrowers on their information gathering and decision making regarding their reverse mortgage, their needs and motivations for obtaining it, their use of funds and whether or not they could continue to live in their homes without the financial assistance provided by the HECM loan. ORC found that HECM borrowers were thoughtful in approaching this topic, did comprehensive research, obtained input from knowledgeable and trusted advisors, found HECM counseling to be useful, utilized the funds to establish greater financial stability for themselves, and felt that without the HECM, it would be challenging for them to remain in their homes.

Despite the growth of the industry and the high level of contentment among borrowers, HUD and the industry did not retreat from the responsibility of perpetual reevaluation and frequent refinements. During this past decade of growth:

- Loan Limits have been adjusted to keep up with needs;
- Loan to value ratios (Principal Limit Factors) have been lowered to protect the FHA Mutual Mortgage Insurance Fund (MMI);
- The Mortgage Insurance Premium has been increased to protect the MMI fund;
- The counseling process has been enhanced with a new intensified protocol requiring the addition of the Financial Interview Tool to evaluate a potential borrower's means to live up to the loan's obligations and benefitscheckup.org, to see what other financial help might be available to them;
- An exam and continuing education requirements were established for all HECM counselors to make sure they fully understand the mechanics of the product, as well as changes that are implemented over time;
- New products, including the HECM Saver and the HECM for Purchase, have been designed and introduced to serve seniors with different needs;
- HUD, FTC, AARP, NRMLA, and now, the CFPB, have worked together to discourage inappropriate and misleading advertising language.

Both our Government partners and our members have had a laser focus on providing this beneficial product to America's seniors and delivering it with the highest ethical values and integrity. At the same time, they have adjusted the program when necessary to keep it aligned with the requirements of and maintain the security provided by FHA insurance.

The history of the HECM program demonstrates that its participants have been thoughtful, careful and responsible. The program has resulted in the growth and development of an important financial management tool that we are able to offer because of the sharing of risk between the public and private sectors.

The lessons learned from the HECM program helped spawn a new market of proprietary reverse mortgages, which prior to the financial crisis of 2009, had started expanding and grew to over 10 percent of the reverse mortgage market. Today, we are beginning to see preliminary indications that investors are studying the opportunity for proprietary reverse mortgage products and are poised to return to this market as the economy stabilizes.

Emergence of HECM as a Proactive Tool for Personal Financial Management

While HECM was initially created to help seniors supplement their retirement income by simply adding in a stream of monthly payments to the homeowner, or creating a stand-by line of credit, use of the loan has evolved to help a number of seniors facing differing circumstances. In some cases, a HECM is utilized to pay off an onerous mortgage and/or other debts. This enables the senior to eliminate monthly payments and deploy their regular cash flow to cover day-to-day living expenses, while being able to remain in the home, rather than having to sell it and move. In other cases, reverse mortgages have been utilized to cover costs for in-home care, allowing borrowers to avoid costly stays in nursing homes—helping to avoid costs that might ultimately have to be borne by Medicaid.

With the introduction of the HECM Saver, which provides lower risk to the FHA insurance fund and lower upfront costs to consumers, the program has drawn interest from financial planners working with older clients. Many retirees experience peaks and troughs in their cash needs over time. As a result, they are often forced to liquidate assets at inopportune times. Rather than selling stocks into a down market, or cashing in Certificates of Deposit (CDs) or other financial instruments before maturity and possibly incurring penalties for doing so, utilization of a HECM Saver can provide cash for immediate needs and then be repaid back into the HECM line of credit when investment values are higher or when CDs mature. The net result, according to models run by leading financial planners, is that the client will have a larger amount of money available to meet their needs through retirement and fund longevity.

Importance of Counseling for Reverse Mortgage Borrowers

A challenge with reverse mortgages is that, to many prospective borrowers, the notion is somewhat counterintuitive. How a reverse mortgage works, how the amount of money available to a homeowner is determined, and how HECMs are priced are topics that are often not fully understood by seniors considering utilizing this helpful tool. As a result, Congress wisely established a statutory requirement that every prospective borrower must meet with an independent third-party reverse mortgage counselor before actually completing a formal application for a HECM loan.

Analyzing how a reverse mortgage might fit into the picture for any particular borrower and learning how to assess the various options available is not a simple task—particularly for older homeowners who might not have been in the financial markets for awhile, for newly widowed individuals whose loss of their spouse's Social Security creates financial insecurity, for seniors struggling to make ends meet, or for those trying to plan ahead to maximize their resources and sustain their financial independence.

Counseling has become a hallmark of the HECM program. It is a very effective consumer safeguard and its impact can be seen in the limited and isolated number of instances where there has been evidence of fraud or elder financial abuse within the HECM program. NRMLA regularly surveys Attorneys General offices in all States, Divisions of Banks, and Departments of Consumer and Elderly Affairs, and all report a very low or no incidence of complaints about reverse mortgages. NRMLA believes that the mandatory counseling is a significant contributor to the integrity of the HECM program.

The opportunity for every prospective reverse mortgage client to consult with an independent, professional reverse mortgage counselor prior to formally submitting a loan application is a critical step that helps consumers make sound decisions. The reverse mortgage counselors are employed by HUD-approved, community-based and nationally designated nonprofit counseling organizations, and each individual counselor must be qualified by passing a HUD-administered exam and meeting continuing education requirements.

The counseling covers several key aspects as delineated in the statute that created the HECM program. First of all, Sec. 255(d)(2)(b) of the National Housing Act requires that:

> To be eligible for insurance under this section, a mortgage shall have been executed by a mortgagor who has received adequate counseling as provided in subsection (f), by an independent third party that is not, either directly or indirectly, associated with or compensated by a party involved in originating or servicing the mortgage, funding the loan underlying the mortgage or engaged in the sale of annuities, investments, long-term care insurance or any other type of insurance or financial product.

Sec. 255(f) further requires:

> The Secretary shall provide or cause to be provided adequate counseling for the mortgagor, as described in Subsection (d)(2)(b). Such counseling shall be provided by counselors that meet qualification standards and follow uniform counseling protocols.
>
> The protocols shall require a qualified counselor to discuss with each mortgagor information which shall include—
>
> 1. Options other than a home equity conversion mortgage that are available to the homeowner, including housing, social service, health, and financial options;
> 2. Other home equity conversion options that are or may become available to the homeowner, such as sale-leaseback financing, deferred payment loans, and property tax deferral;
> 3. The financial implications of entering into a home equity conversion mortgage;
> 4. A disclosure that a home equity conversion mortgage might have tax consequences, affect eligibility for assistance under Federal and State programs, and have an impact on the estate and heirs of the homeowner; and
> 5. Any other information that the Secretary may require.

The result of this has been the development of a robust network of committed counseling organizations and qualified individuals to deliver the HECM counseling, either in face-to-face sessions or via telephone, depending on each client's personal choice and mobility. This counseling network has ably served the needs of older homeowners considering HECM loans and has grown in capacity and sophistication as the decisions that go into evaluating a HECM get ever more complex.

One particular area that has emerged, and both NeighborWorks and National Council on Aging (NCOA), two of the primary providers of reverse mortgage counseling and training, are to be commended for stepping up to the plate to deal with the issue, is providing remedial counseling to reverse mortgage borrowers who have had setbacks in their financial affairs and have had difficulties meeting their obligations to pay property taxes and insurance. Failure to pay these so-called "property charges" represents a technical default under the HECM program.

When a borrower falls into technical default, the loan servicer is obligated to pay such charges on their behalf to protect the FHA insurance fund and begin working with the borrower to bring the account current. HECM counselors play an integral role in providing remedial assistance and advice for borrowers in technical default.

As a result of these remedial counseling services, many HECM borrowers facing this situation have been able to arrange a repayment plan to reimburse the lender's advances, protecting FHA from possible payouts for claims, while preserving the homeowner's ability to continue living in his/her home—a win-win solution for all involved.

Standards for HECM counseling are very specific and stringent. They are the product of an ongoing collaborative effort among a varied group of stakeholders including HUD, senior advocacy groups, gerontology experts, housing counseling professionals and experienced lenders. They have proven to be very effective to date and have been considerably enhanced with the introduction of updated HECM counseling protocols 3 years ago.

Current Issues Impacting the HECM Program

1. Performance of Various Years "Books of Business"

There is concern about the overall health of FHA's Mutual Mortgage Insurance Fund (MMIF), of which HECM is a part. In the invitation to testify at today's hearing, the Committee has asked if the current state of FHA is due to the unprecedented decline in the housing market or if the mission of FHA is flawed?

Clearly, to us, FHA is fulfilling a mission that is necessary and useful in helping older Americans remain in and maintain their homes. Aging in place is the most cost effective alternative for many households. HECM is a critical resource for helping seniors do so.

The financial challenges the program faces are directly a result of the decline in the housing market over the past few years. The major factor creating stress on the program is the diminution of housing values from 2009 through part of 2012. Because HECM loans rely on the future value of the home for repayment, diminished values have an even more severe impact on reverse mortgages than on other types or mortgage loans.

The earlier books of business under the HECM program, loans made from 1990 through 1996, essentially paid-off successfully before home values crashed in 2009.

The books of business originated from 1997 through 2008, had all been projected to perform in an actuarially sound manner and only became a challenge as a result of the unforeseen collapse in the housing markets. Because these loans were made with lower loan limits and expected interest rates that were higher than the actual rates in recent years, as home price appreciation improves, many of these loans will get back on track. In fact, earlier this week, Standard & Poor's reported that home prices in January 2013 increased 6.8 percent from January 2012, a significant improvement from the forecast utilized in the FHA actuarial assessment conducted last June. In Phoenix, a particularly troubled market, prices are up 23 percent in the past year; Atlanta is up 9.9 percent; Detroit is up 13.6 percent.

The loss severity of the 2010 and 2011 books of business has been moderated somewhat by cuts in the Principal Limit Factors (loan to value calculations) and increased Mortgage Insurance Premiums mentioned earlier in this testimony. The improved outlook for home price appreciation will have a strong positive impact on these portfolios.

The 2012 and 2013 books of business were assessed to have a positive economic value in the recent actuarial review. Furthermore, FHA has adjusted its expectation of future home price appreciation for these newer loans, utilizing a more conservative estimate of 2 percent per annum (in the 2013 book), rather than the 4 percent that had been utilized historically, further enhancing the expectation of positive performance for these portfolios.

That leaves the problematic portfolio of loans originated in 2009, when home values were at their peak, and before FHA cut the Principal Limit Factors and raised the Mortgage Insurance Premiums for the later books. However, with stronger performance in the housing markets and the improvements we are witnessing in home price appreciation, plus the vastly improved outlook for newer loans, we believe FHA has the opportunity to "earn" its way out of the negative estimate of economic value for the 2009 HECM portfolio, particularly if given the tools necessary to properly manage its risks going forward.

2. Ability of FHA To Act Expeditiously in Making Program Changes To Manage Risk and Strengthen the HECM Program

One of the challenges HUD has faced in managing the HECM program has been its inability to move swiftly in making programmatic changes that could enhance the security and financial performance of the Mutual Mortgage Insurance Fund. Reverse mortgages are a relatively new concept and there has been a learning curve as HUD and the industry have observed how these loans perform. While some of the lessons to date have been translated into program improvements as described earlier in my testimony, others await implementation. Unfortunately, during the downturn, HUD was unable to move fast enough in making some desired changes.

This is due to the circuitous route that HUD must follow to modify its regulations. Changes to many aspects of the HECM program must be made in accordance with the Federal Administrative Procedures Act and generally take up to 2 years to be implemented. If FHA is granted the authority to modify the HECM program through the issuance of Mortgagee Letters, in lieu of Rule changes, program changes and enhancements could be implemented in a matter of months, not years.

There are a few adjustments that FHA can currently do by Mortgagee Letter, such as changing the principal limit factors—something that they are currently doing to essentially implement a moratorium on the Fixed-Rate (full draw) HECM Standard loan option. However, there are other thoughtful, longer-term solutions to strengthen the program that currently require pursuing the formal regulatory development process.

Changes that FHA would like to implement, and which the industry supports, include:

A. Establishing a financial assessment process, essentially a new approach to underwriting, being developed specifically for HECM borrowers, that would require lenders to ascertain a prospective borrower's likely ability to meet all of his or her obligations under the loan, including paying taxes and insurance;

B. Requiring set-asides or escrows for taxes and insurance;

C. Introducing restrictions on initial draws and/or utilization of funds.

Both Assistant Secretary for Housing/Federal Housing Commissioner Carol Galante, in recent testimony before this Committee, and the 2012 Independent Actuarial Report on the Mortgage Mutual Insurance Fund suggested that it would be helpful if Congress provided HUD with the authority to make such changes through the issuance of Mortgagee Letters. NRMLA urges Congress to quickly grant HUD that authority.

3. Authorization Cap

A major issue faced by the reverse mortgage industry is that, while the HECM program was made permanent back in 1998, there has been a statutory limit on the number of loans FHA is authorized to insure. Although the cap has been routinely raised or suspended by Congress in a series of consecutive appropriations measures and continuing resolutions, the existence of the cap deters some industry participants from making the commitment required to fully embrace reverse mortgage lending, thus keeping competition in the market at a minimal level.

NRMLA urges Congress to support the continued availability of Home Equity Conversion Mortgages by permanently removing the cap on the number of HECMs that FHA may insure to minimize any possible disruption in the availability of this importance personal financial management tool.

While there might be some concern about monitoring the program to assure that it operates on a fiscally sound basis, the review undertaken annually in the budget process provides that opportunity. There are also opportunities for review whenever this Committee conducts its periodic and helpful oversight of the program, or of FHA generally.

4. Tax and Insurance Defaults

Homeowners with HECM loans are required to keep their properties properly insured, plus pay taxes and any applicable homeowner association fees. If they fail to do so, the loan servicer is required to advance such funds on their behalf, from the borrower's line of credit, if funds are available, or from the loan servicer's own funds if no funds are available in the HECM account. Once a loan servicer advances funds for these purposes, it is required to work with the borrower to recover the funds advanced through a repayment plan. If the borrower continues to fail to meet that obligation, the loan is in "technical default" and the loan servicer must go to HUD and request permission to call the loan due and payable.

Earlier on, some HECMs were made to homeowners who eventually proved to be unable to meet these obligations. This has resulted in several new initiatives to minimize issues caused by technical defaults. FHA now requires loan servicers to report delinquent borrowers in a more timely fashion and to work with them and a special task force of counselors trained in remedial strategies for dealing with such defaults.

Counseling protocols have been enhanced to make sure that the responsibility for paying these so-called property charges is explicitly discussed upfront in counseling sessions with all borrowers. Lenders have become much more direct in discussing this obligation with prospective borrowers and are beginning to implement procedures designed to identify applicants who might not be able to meet their obligations.

The items discussed earlier in my testimony, including financial assessment as part of the loan origination process, and the establishing of tax and insurance set-asides, would help address this issue. Right now, HUD may only implement these items through the formal promulgation of regulations. We believe these items should be implemented quickly and, once again, urge Congress to give FHA the authority to address such items through the issuance of Mortgagee Letters, a much more expedient process.

Conclusion

The FHA Home Equity Conversion Program has been a useful tool, helping hundreds of thousands of seniors maintain their homes and lead more financially stable lives. The program has been administered thoughtfully, carefully and responsibly by a partnership of stakeholders including HUD, the lending community, senior advocacy groups like AARP and National Council on Aging, and the housing counseling network. This has allowed the reverse mortgage concept to gain a foothold and prove the value of this important personal financial management tool as a component of retirement finance and funding longevity.

We thank the Members of this Committee for your continual interest in the HECM program and hope that we can count on Congress to demonstrate its support by granting HUD the authority to make programmatic changes swiftly and by eliminating or permanently suspending the cap on the number of HECM loans that FHA is authorized to insure.

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FEBRUARY 28, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify on the financial condition of the Federal Housing Administration. I am a professor at the University of Maryland's School of Public Policy and a faculty affiliate of the Center for Financial Policy at the Robert H. Smith School of Business at the University of Maryland. I am also a visiting scholar at the American Enterprise Institute and a senior fellow with the Milken Institute's Center for Financial Markets. I was previously Assistant Secretary for Economic Policy at the Treasury Department from December 2006 to January 2009.

Reforms are urgently needed to ensure that the Federal Housing Administration (FHA) plays its important role in helping to expand access to mortgage financing for low- and moderate-income families who have the financial wherewithal to become homeowners. The fiscal condition of the FHA has deteriorated considerably in recent years, to the point at which the FHA nearly required a bailout last year and might well be required to draw on the Treasury this year to ensure its continued solvency. The FHA continues to have an outsized share of the housing market, especially for purchase loans, and thus displaces private sector activity, while providing backing for some houses worth more than $700,000—a level at odds with its mission. Moreover, the FHA underprices its insurance according to the appropriate measures reported by the Congressional Budget Office (CBO), meaning that taxpayers are not fully compensated for the housing risk they are taking on through FHA's guarantees.

Over the past several years as its financial outlook has worsened, we have all learned the hard way that the FHA grew too large and took on too much risk. Indeed, the Government Accountability Office (GAO) earlier this month added the FHA to its high-risk list, reflecting the need for actions to "restore FHA's financial soundness and define its future role." [1] The financial fallout of this risk is encapsulated in the 2012 independent actuarial review indicating that the economic value of the FHA's Mutual Mortgage Insurance Fund (MMIF) is negative $16.3 billion. This is a continuation of the deterioration of the MMIF's economic value from positive $4.7 billion in 2010 and positive $2.6 billion in 2011, and comes despite useful actions taken by the FHA to improve its risk management and lender enforcement.

The first step in solving a problem is to acknowledge that one exists. This was not always the case with this Administration, as can be seen in the dismissive response of the Department of Housing and Urban Development in 2011 to warnings from outside analysts such as Wharton Professor Joe Gyourko that the FHA was underestimating its risks on single-family mortgage guarantees, and that the capital position of the FHA needed to be improved to deal with these risks. [2] In this regard, it is laudable that the 2012 actuarial review adopts technical recommendations from the GAO, the HUD inspector general, and others to better model the risks and potential losses facing the FHA. These changes, along with a more realistic outlook for economic variables such as home prices, account for a good deal of the worsening of the FHA economic value. This revised outlook is not welcome news, but it is best to understand the risks clearly so that the FHA can take the actions necessary to be in a position to fulfill its mission.

The mission of the FHA is not flawed. Indeed, it is admirable that 78 percent of FHA home purchase loans in fiscal year 2012 went to first-time homebuyers, and that the FHA helped support around half of the home purchase loans made to African American and Hispanic borrowers. The key is for steps to be taken so that the FHA can continue to fulfill its mission in as effective a fashion as possible while protecting taxpayers.

More needs to be done to safeguard the financial stability of the FHA and thus to ensure that it carries out its mission; to protect taxpayers against even greater losses and the possibility of a future bailout; and to boost overall U.S. economic growth by ensuring that the private sector and not the Government plays the leading role in allocating capital. I focus below on policy measures that would achieve these goals while better targeting Government resources that are deployed in the

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[1] *See,* Government Accountability Office, 2013. "High-Risk Series: An Update", Report GAO-13-283, February.

[2] *See,* Joe Gyourko, November 21, 2011. "Response to HUD on FHA Risk Evaluation", available on *http://real.wharton.upenn.edu/gyourko/Working%20Papers/Response%20to%20HUD%20on%20FHA%20Risk%20Evaluation%20Nov%20%2021%202011-jg.pdf*

form of support for home ownership through the FHA to families who most need assistance to become homeowners.

To be sure, the unwelcome financial condition of the FHA reflects the effects of the collapse of the housing bubble, ensuing recession, and subpar growth of jobs and incomes over the past 4 years. The combination of these developments led to elevated losses on FHA-guaranteed mortgages originated from 2000 to 2009, and especially on loans made starting in 2007 when the shutdown of subprime lending led riskier borrowers to migrate toward FHA-backed loans. The effects of these loan guarantees are still felt, as indicated in the most recent figures for the National Delinquency Survey released by the Mortgage Bankers Association that show a slight increase in delinquencies for FHA-backed loans at the end of 2012 when delinquency rates for other types of loans continued to decline.

These various factors affecting FHA-backed loans provide an explanation of the FHA's situation but not an excuse. Indeed, the negative value of the MMIF came about because the underwriting standards, insurance pricing, and other practices of the FHA have taxpayers provide an underpriced guarantee with 100 percent coverage of the mortgages taken out by risky borrowers, many with scanty downpayments and thus little protection against home price declines.

Some of the practices which brought about the FHA's problems have changed, with an end to seller-funded downpayments, some changes to practices for home equity conversion mortgages (HECM; so-called reverse mortgages), and increased actions to address problematic originators and underperforming servicers. But more needs to be done to protect taxpayers, to target FHA activities more effectively, and to ensure that the costs, risks, and benefits of FHA activities are transparent , accurately accounted for in Government books, and understood by policy makers and the general public. In doing so, the FHA should return to its traditional share of about 10 to 15 percent of the housing finance market so that Government does not take on an inappropriately high level of risk and distort the housing market.

In considering reforms, it is important both to address the present solvency concern and to ensure that the FHA is focused on its core mission while avoiding risks that pose a threat to its future solvency. Maintaining an oversized FHA is not the best approach to addressing solvency either today or into the future. With insurance premiums that appear still to underprice risk, a continued large footprint for the FHA compounds the solvency risks rather than addresses them. Moreover, maintaining an outsized role for the FHA means increased distortions in the broad housing market as the Government seeks to artificially boost demand for housing—an approach that in the past led to considerable suffering for borrowers who prematurely attempted to take on the financial responsibilities of home ownership. It is intrinsically proconsumer to strengthen underwriting standards to ensure that borrowers are capable of staying in their homes. The FHA Emergency Fiscal Solvency Act considered by the Committee in 2012 is a useful starting point for reform but is not enough. Additional measures are needed to ensure the solvency of the FHA, reduce its market share, and improve its efficiency, effectiveness, and ability to manage risk.

Measures that should be taken as part of FHA reform include:

1. *Improve the pricing of FHA insurance.* As was included in the FHA Solvency Act, it would be useful to increase both the minimum and maximum annual premiums on FHA loans and to utilize the scope for pricing insurance in line with risks. In the meantime, the FHA should use its existing authorities to tighten its insurance pricing. These steps will mean higher costs for homebuyers, but this reflects the risks borne by taxpayers. At the very least, the FHA should use its existing scope to raise annual insurance premiums until the MMIF regains its minimum required 2 percent capital ratio.

   An important consideration is that Fannie Mae and Freddie Mac are taking steps to increase the pricing of the insurance they offer on mortgages and also eventually to require private capital in a first-loss position ahead of the Government guarantee. Absent corresponding action by the FHA, borrowers who might otherwise qualify for conforming loans backed by Fannie and Freddie will migrate toward the FHA and its less stringent underwriting standards. This could lead to increased risk for the FHA and thus greater net exposure for taxpayers since loans backed by the FHA are riskier than those backed by Fannie and Freddie. This concern is illustrated by the experience starting in 2006 when the shutdown of subprime origination resulted in borrowers turning to FHA-backed loans for mortgages, with dire consequences for the financial condition of the FHA.

2. *Require higher downpayments for additional categories of relatively risky borrowers.* The FHA is unusual in allowing borrowers to have relatively modest

downpayments. While this helps first-time homeowners who have not accumulated the resources for larger downpayments, a lesson of the recent crisis is that housing prices go down as well as up, and that ensuring that borrowers have equity in their home is vital to avoid foreclosures and to safeguard the stability of the housing market. As noted above, it is intrinsically proconsumer to ensure that homebuyers get into houses and mortgages that they can sustain. The FHA now requires 10 percent downpayments for borrowers with FICO scores below 580. It would be useful to add a tier with a required downpayment of 5 percent for borrowers with FICO scores from 580 to around 620 (with the precise cutoff depending on an evaluation of risk factors). As an alternative, borrowers could be offered a choice of retaining the lower downpayment with a shorter loan term such as 20 rather than 30 years. The goal is to ensure that risky borrowers build up an sizable equity stake in their homes relatively quickly. The Committee should also consider whether borrowers with very low FICO scores such as 500 to 580 should be eligible for FHA-backed loans in the first place.

3. *Reduce FHA loan limits* in order to shrink the FHA market share and focus Government assistance on homebuyers who most need assistance. The current loan limit of up to $729,000 means that the FHA is serving a population far outside of its mission, and this would still be the case if the FHA loan limit is allowed to revert to $629,500. It is misguided to assert that the FHA should continue to insure these high-dollar loans because they are profitable and will help to recapitalize the MMIF. As discussed below, the FHA books profits under Government accounting procedures that understate the risks of its activities. Indeed, the FHA loan limit exceeds that for mortgages guaranteed by the U.S. Government through support for Fannie Mae and Freddie Mac, even though the underwriting requirements for those two firms are more conservative than those of the FHA. Moreover, the FHA activity displaces the private sector to the detriment of the overall U.S. economy. Even if jumbo loans above the GSE conforming loan limits were profitable for the FHA, it would be better to allow the private sector to gauge the creditworthiness of people seeking to buy homes of three-quarters of a million dollars or more (including the downpayment on top of the maximum loan amount). It is noteworthy that the recent report from the Bipartisan Policy Center's (BPC) Housing Commission calls for loan limits for Government-backed loans to be set at $275,000 in order to focus public support on families most in need (and then would accompany this with increased spending to support affordable housing for both owner-occupied and rentals).[3]
4. *Use Fair Value accounting to evaluate the costs involved with FHA lending activities.* As explained by the group of eminent academics at the Financial Economists Roundtable of the Wharton Financial Institutions Center at the University of Pennsylvania, the current accounting of FHA guarantees under the Federal Credit Reform Act of 1990 (FCRA) systematically understates the costs and risks of FHA activities.[4] The understating of risk comes about because the FCRA accounting treatment ignores several types of risks that are borne by taxpayers when making guarantees on private sector activities. As an illustration, under the FCRA accounting treatment, the Federal Government would book a profit if it simply buys a loan from the private sector at the accurate market price. The profit comes about because the FCRA rules discount the future cash flows from the loan by the interest rate on Treasury securities rather than the higher interest rate that was used by the private lender when it made the loan. In reality, the Federal Government does not have any inherent advantage over a private lender at managing the risk of a loan and there is no reason to believe that an otherwise identical loan is any more valuable if owned by the Federal Government rather than by a private lender. The profit booked in this example is illusory; it is an artifact of the FCRA accounting treatment. This illusion of profits is the case now with the accounting treatment of FHA guarantees. The FHA books a profit when it guarantees loans to riskier borrowers and on less stringent terms than loans that private sector lenders would be willing to make.

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[3] For the recommendations of the BPC commission, *see, http://bipartisanpolicy.org/projects/housing*.

[4] *See,* "Accounting for the Cost of Government Credit Assistance", October 16, 2012 statement of the Financial Economists Roundtable. Available on *http://fic.wharton.upenn.edu/fic/Policy%20page/FER%20Statement%202012%2010-16-12%20final.pdf*

Use of the fair value accounting treatment would not reduce the merits of FHA activities in any way. Fair value accounting would simply measure the risks involved more accurately. The CBO assessment of these risks indicates that the 1.9 percent profit rate (that is, the negative 1.9 percent subsidy rate) for FHA loan guarantees calculated under the FCRA accounting treatment is more accurately measured as a 1.5 percent cost (a positive subsidy rate) using fair value accounting.[5]

Opposition to the use of fair value accounting seems to reflect the outcome of a higher cost rate and the concern that assigning a cost rather than a profit to FHA activities would lead to less Government support for the FHA. I do not agree. The activities of the FHA are a vital part of the overall Government support for housing. These activities are so important that they should be undertaken and paid for with a clear recognition of the costs and risks. Use of fair value accounting is not a mechanism by which to reduce the scope of FHA activities, but rather a move toward a transparent understanding of their costs. Indeed, the experience of the past several years illustrates that the risks of FHA activities have been consistently underestimated.

Fair value accounting is used to accurately gauge the costs of Government support for Fannie Mae and Freddie Mac, and a variant of fair value accounting has been used to measure the costs and risks of Government support through the TARP. It is no less important to accurately measure the costs of FHA guarantees.

5. *Expand indemnification authority so that the FHA can pursue claims against all lenders.* The FHA has requested improved indemnification authority along several dimensions, as well as authority to terminate origination and underwriting approval, to change the compare ratio requirement to provide greater flexibility, and authority to transfer servicing. These are useful steps to take. Indeed, the FHA should fully pursue inappropriate actions on the part of originators and servicers. At the same time, it should be recognized that greater indemnification authority is an important step, but not a cure-all for the FHA solvency issues, present or future.

A useful accompanying step on the part of the FHA would be to provide clearer information on the rules and procedures governing underwriting standards and quality control reviews, and on the factors that lead to an indemnification request. The FHA should provide feedback to lenders on an ongoing basis to minimize defects and losses to the FHA and to reduce the risk borne by lenders. Taking these clarifying steps could reduce the use of so-called lending overlays under which originators impose more stringent lending standards than required by the FHA.

6. *Require increased capital at the FHA and plans to maintain capital levels.* The current requirement of a 2 percent capital ratio has proven inadequate, suggesting that reform should increase the capital maintained against losses. This would mirror developments in other parts of the financial sector, where firms such as banks are appropriately being required to maintain increased capital levels. Any time the capital level is projected to dip below the required level, the FHA should be required to provide a plan to Congress on how it will restore the needed capital level. This added accountability of the FHA is important for providing Congress with a mechanism with which to monitor FHA performance.
7. *Further reduce maximum allowable seller concessions* to avoid inflated appraisal values. FHA has taken important steps through administrative actions to address seller concessions. It would be useful to codify these changes in legislation.
8. *Improve transparency with better information on foreclosure risks and costs.* FHA reporting to Congress and the public could usefully provide more detailed information on the factors and combinations of factors that are associated with increased risk of loss for the MMIF. It would be especially useful to establish a program to review the cause of early period delinquencies of FHA-backed loans.
9. *Make the FHA risk office permanent.* This useful innovation should be codified in legislation.

[5] *See,* the May 18, 2011 CBO letter to Representative Paul Ryan on "Accounting for FHA's Single-Family Mortgage Insurance Program on a Fair-Value Basis", Available on *http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/120xx/doc12054/05-18-fha_letter.pdf*

10. *Impose consequences in the event that the FHA requires a bailout from the Treasury.* At the minimum, the necessity of drawing money from the Treasury should trigger an automatic report to Congress with an explanation for the bailout and a plan to avoid future bailouts. More frequent independent actuarial studies of the MMIF should be required when the fund is below its required capital ratio.

In addition to these steps, Congress should consider other actions in the context of FHA reform legislation, including:

1. Income tests on FHA borrowers to focus the mission. An income test would ensure that the FHA serves borrowers who most need assistance. It is hard to understand why a family with a high annual income purchasing a home that costs over $700,000 should be eligible for an FHA-backed loan. To be sure, most FHA-backed borrowers are not in this category, but there is no reason for such homebuyers to be eligible in the first place. It is especially worrisome that the FHA views these borrowers as a way to book profits rather than as the diversion of Government resources away from families who truly need assistance to become homeowners.
2. Increase the role of private capital and reduced the Government exposure to credit risk. It would be useful to examine possibilities for FHA-backed loans to be made in which there is first-loss private capital ahead of the Government guarantee. This could be at the individual loan level such as by including private mortgage insurance (PMI), or at the level of the mortgage-backed security (MBS). Having private capital ahead of the Government guarantee would protect taxpayers while providing incentives for improved origination quality (since investors will require this to take on the first-loss risk of FHA-backed loans). An additional step to reduce the Government exposure to risk would be for the FHA guarantee to cover less than 100 percent of potential mortgage losses. This is already done by the Veterans Administration (VA) in providing guarantees for mortgages, and VA-backed loans have considerably more favorable performance in terms of fewer delinquencies than FHA-backed loans. This is not surprising since private investors exposed to credit risk in the VA loan program have "skin in the game" and thus incentives to focus on careful loan origination.
3. Require private capital in a first-loss position ahead of FHA guarantees on multifamily and health-related mortgages. The multifamily divisions of Fannie Mae and Freddie Mac both require private capital ahead of their guarantees, and have considerably better loan performance than for multifamily residential mortgages bundled into commercial mortgage backed securities. This again reflects the beneficial incentives brought about when market participants have their own capital at risk.
4. Restrictions on FHA backing for borrowers with recent foreclosures. The FHA might specify that borrowers who have been foreclosed on in the past several years are not eligible for FHA-backed loans.

Putting these reforms into statute is important for providing certainty to borrowers and to all participants in the housing industry. The details of each of these ideas should be tested by the Committee against careful underwriting analysis.

An important broad point is that changes in other parts of the housing finance system will affect the FHA. The qualified mortgage (QM) rule from the Consumer Financial Protection Bureau is likely to lead private originators to avoid non-FHA loans with debt-to-income ratios above 43 percent. With the FHA still willing to provide a guarantee for borrowers with higher debt service burdens, it would be natural to expect a migration of risky borrowers to the FHA. This illustrates the importance of strengthening underwriting standards at FHA. Careful underwriting helps protect taxpayers against risk, but strong underwriting standards are also intrinsically proconsumer in that they help ensure that borrowers get into homes that they can sustain.

Conclusion

The solvency challenge facing the FHA requires legislative action. Indeed, reform of the FHA is essential to ensure that the FHA remains effective at carrying out its mission; to protect taxpayers; and to ensure that Government actions do not unduly interfere in the allocation of capital by the private sector and thereby detract from U.S. economic growth.

Several years into the economic recovery, the FHA market footprint is still enlarged relative to the historical norm and the agency faces challenges managing risk. FHA activities are evaluated using an accounting framework that understates

the potential costs to taxpayers from the risks taken on through the FHA guarantees. And the FHA serves buyers of homes that are too costly to be plausibly related to the mission. It is vital to take immediate steps to stabilize and refocus the FHA. These steps should not wait for other developments.

FHA reform further can be helpful for setting the stage for subsequent reforms of the housing finance system, notably including reform of the Government-sponsored enterprises (GSEs) of Fannie Mae and Freddie Mac. Looking ahead, as the FHA returns to its historical market share of 10 to 15 percent, and as the GSEs eventually are reformed, this will put in place the conditions for a larger share of mortgage financing to be performed without a Government guarantee. To avoid the prospect of an immense amount of new lending landing on bank balance sheets and making big banks even larger, it will be useful instead to have a larger scale restart of private label securitization. It would be useful in this regard for the Committee to examine the impediments to nonguaranteed securitization.

It is important to move forward immediately with FHA reform, but not to stop there. Over time, reforms of the U.S. housing finance system are needed to best serve American families, to protect taxpayers, and to once again make it possible for the housing sector to make a strong and sustained contribution to U.S. economic growth and job creation.

PREPARED STATEMENT OF SARAH ROSEN WARTELL

PRESIDENT, URBAN INSTITUTE

FEBRUARY 28, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I thank you for the opportunity to testify today about the Federal Housing Administration's (FHA) current financial condition and the challenges that the agency faces in the aftermath of the housing crisis.*

I am Sarah Rosen Wartell, president of the Urban Institute. For 20 years, I have worked on housing finance policy issues. I began my career in public policy with a 5-year stint as an official at FHA, advising FHA Commissioner Nicolas Retsinas and HUD Secretary Henry Cisneros on housing finance, mortgage markets, and consumer protection. I held a variety of positions at FHA including deputy assistant secretary for operations and associate general deputy assistant secretary for housing, and I helped develop a 1995 proposal (never adopted by Congress) to transform FHA into "a results-oriented, financially accountable [Government corporation known as the Federal Housing Corporation that would] utilize the strengths of private market partners to expand home ownership opportunities, . . . [while continuing] to serve the needs of working families who require low-downpayment loans, and residents in central cities, older neighborhoods, and other underserved markets, and develop more affordable rental housing."[1]

After HUD and my subsequent tenure as deputy assistant to the president at the National Economic Council in the White House, I served as a consultant to the bipartisan Millennial Housing Commission, where I wrote about how FHA faced management weaknesses and growing risk with inadequate risk management tools. I proposed single-family risk-sharing as one potential strategy to help FHA protect taxpayers while serving its mission more effectively.[2] Later, in 2007, at the Center for American Progress, I convened the Mortgage Finance Working Group, a cross-sector coalition of individuals working to understand and develop policy responses to the emerging mortgage market crisis. Now, at the Urban Institute, I am responsible for leading an organization that provides research and analysis on a wide array of issues, from tax policy to community development to health care and more. The Institute is working to launch a new research initiative with the capacity to

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* Sarah Rosen Wartell is the president of the Urban Institute. She is indebted to Ed Golding, Sharon Carney, Taz George, Brian Chappelle, and Ellen Seidman for their assistance in preparing this testimony and Mark Willis and other participants in a roundtable on the future of FHA for helping to shape some of the concepts described herein. The views expressed, however, are solely her own and should not be attributed to the Institute, its employees, or any other person or organization with which she is affiliated.

[1] "Reinvention", by Henry Cisneros, June 29, 1995, available at *http://archives.hud.gov/remarks/cisneros/whyhud/reinvent.cfm.*

[2] Sarah Rosen Wartell, "Single-Family Risksharing: An Evaluation of Its Potential as a Tool for FHA", June 2002, available at *http://govinfo.library.unt.edu/mhc/papers.html.*

provide data and independent analysis to inform policy makers on housing finance questions.

This testimony describes the role that FHA has played historically and during the most recent financial and housing market crises. As the Committee requested, I also look at the origin of losses expected from the FHA insurance portfolio. In short, these losses stem in part from specific products that proved costly and FHA's difficulty in quickly identifying and shutting down problematic originators and underperforming servicers; however, these losses stem in larger part from rapidly falling home values amidst a foreclosure crisis and job losses arising from the deepest recession in many, many decades.

In short, many of these costs are inevitable—the result of FHA playing an indispensable countercyclical role, without which losses to the U.S. economy, U.S. homeowners, and U.S. taxpayers through the conservatorship of Fannie Mae and Freddie Mac would have been far greater. But some of these costs might have been avoided if FHA had more analytic capacity and additional tools and authorities to act nimbly to manage, price, and mitigate risk.

Looking forward, the Fund's capital reserve must be replenished. And FHA's role can be more targeted to supporting lower-wealth, moderate-income families through the reduction of loan limits. Congress also can enhance FHA's capacity to act quickly to reduce the level of defaults and the severity of losses. I will describe some of the steps that could be taken that would give FHA officials the ability to act quickly to make programmatic changes that would reduce losses. These steps offer good prospects for further reducing risks to the Fund and protecting taxpayers now and in the future.

At the same time, I caution against extreme measures that would prevent FHA from serving its core missions: (1) providing the critical countercyclical backstop necessary to break a vicious cycle of housing market decline and the accompanying flight of private capital; and (2) ensuring access to credit for creditworthy borrowers who have limited private-market options. And I argue that we cannot answer some critical questions about FHA's role in a vacuum without understanding the shape of the mortgage finance system after the conservatorship of Fannie Mae and Freddie Mac comes to an end and the Government's role in the conforming market is scaled back.

The Historic and Recent Role of FHA

FHA has played a critical role over the years in promoting sustainable home ownership. Before the creation of FHA, families put off home ownership until they had accumulated sufficient wealth to buy a house outright or to borrow just a small fraction of the funds. Balloon payments were typical, so interest rate shifts could mean the inability to refinance and the loss of a home. As a result, home ownership, with its many positive societal benefits, was delayed and often never realized.

At the time FHA was created in 1934, the home ownership rate stood at approximately 46 percent. FHA demonstrated that, with proper underwriting and due care not to layer risk, those with very little wealth but steady employment could responsibly borrow money to purchase a house. FHA pioneered the long-term, self-amortizing, low-downpayment mortgage that allowed millions of American families to afford home ownership. Partially as a result of FHA, home ownership rose to almost 63 percent by 1970.

The research literature shows that home ownership correlates with improved outcomes for children, reduced crime, and higher civic participation. Home ownership is still the primary form of wealth creation for middle-class families. For families in the middle income quintile, approximately half of net worth is from housing equity.[3] Families that delay home ownership by 10 years will have, on average, $42,000 less in net assets at retirement.[4] At the same time, of course, foreclosure is adversely correlated with surrounding home values and outcomes for children and crime.[5] [6] In other words, sustainable home ownership has positive benefits, but indiscriminate home ownership does families and society no favors. The goal must be a balanced policy offering affordable and family friendly rental housing options

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[3] Mauricio Soto, "Family Net Worth before the Recession", The Urban Institute, March 2010, available at *www.urban.org/publications/412078.html.*

[4] Roya Wolverson, "Rent Nation", *TIME,* September 24, 2012, p. 52 (citing Signe-Mary McKernan, whose calculations are based on Gordon B.T. Mermin, Sheila R. Zedlewski, and Desmond J. Toohey, "Diversity in Retirement Wealth Accumulation", The Urban Institute, December 2008, available at *www.urban.org/UploadedPDF/411805*).

[5] "Do Foreclosures Cause Crime?" Furman Center for Real Estate & Urban Policy, February 2013.

[6] Atif Mian, Amir Sufi, and Francesco Trebbi, "Foreclosures, House Prices, and the Real Economy", National Bureau of Economic Research working paper, May 2012.

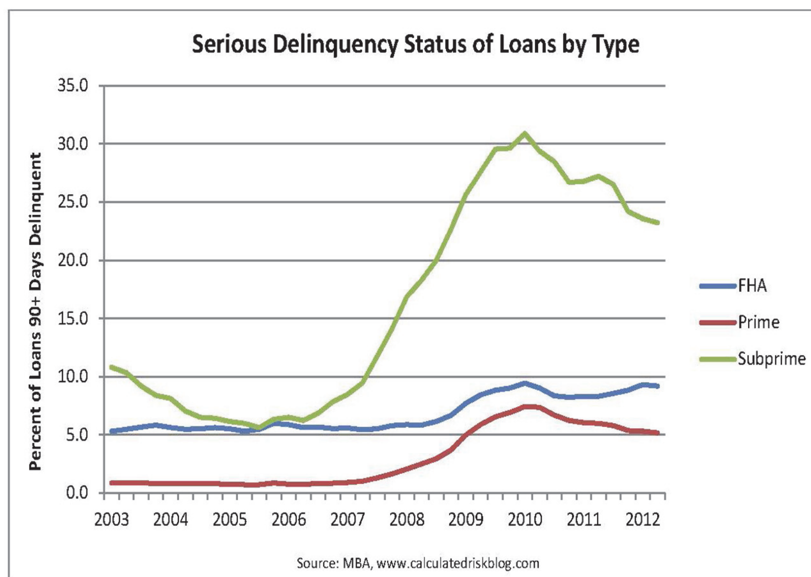
along with “home ownership done right” for those ready and eager to sustain a mortgage.

While FHA mortgages total roughly $1 trillion of the $10 trillion mortgage debt outstanding, or approximately 10 percent of the market by dollar, the program plays a disproportionate role among first-time homebuyers. Historically, FHA served approximately half of first-time homebuyers. Recently, it has been closer to three-quarters.[7]

In addition to supporting first-time homebuyers, FHA serves markets that have historically been either underserved or poorly served by private markets. The availability of refinancing and the ability to “trade up” and purchase subsequent homes are important ways in which limited wealth is acquired in minority and underserved communities. In 2010, FHA-insured mortgages accounted for nearly 60 percent of all originations among African American and Hispanic households, compared to 33 percent among all white households. Similarly, FHA-insured mortgages are more likely to be in communities with below-median income.[8] When the private sector serves these markets, it has often been with subprime mortgages with default rates significantly higher than those of FHA-insured mortgages; these mortgages have led to loss of homes at an alarming rate.

This point is worth emphasizing: while FHA defaults are too high right now, its default rates are still well below the subprime lending originated in the last decade principally with private-label securitization. (*See,* Figure 1.) Thus, when FHA serves communities of color and minority homebuyers, the outcomes have typically been better than when the private market did so without Government support. To be clear, I am not saying that the performance is good enough. Unfortunately, at times realtors and others steered borrowers to FHA-insured mortgages and originated loans with too little focus on capacity to repay, with adverse implications for not only the individual borrowers, but the communities as well. We must continue to strive to improve the performance of FHA lending, for the benefit of the homeowners, their communities, and the taxpayers. But we also must recognize that—absent FHA—availability of credit, homeowner equity, and community stability in many underserved communities would be even more limited.

Figure 1



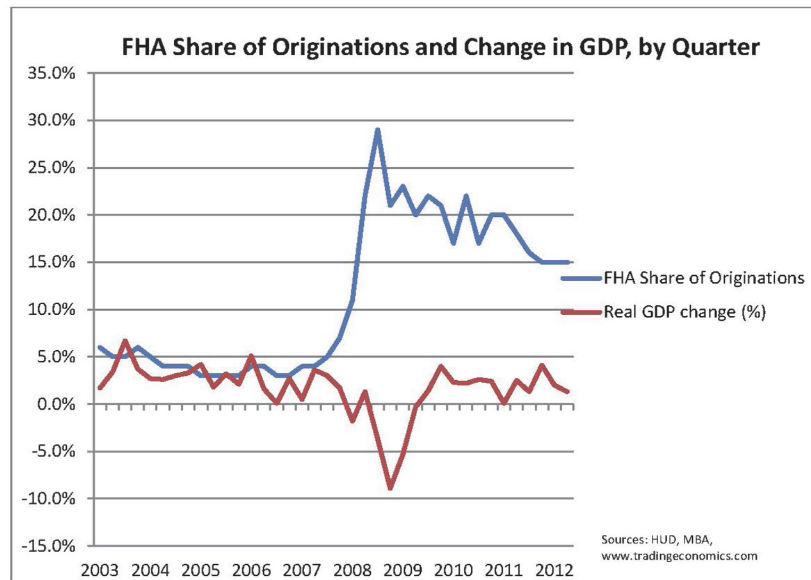
[7] Edward Szymanoski, William Reeder, Padmasini Raman, and John Comeau, “The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market”, U.S. Department of Housing and Urban Development working paper, December 2012.

[8] Ibid.

FHA's role as a provider of credit to minority and underserved borrowers could prove especially important given changing demographics, unless the private market proves more adept at serving these homebuyers. The housing market will be ever more diverse, with minorities expected to make up 70 percent of new net households over the decade.[9]

In addition to promoting home ownership, FHA plays a critical role as a countercyclical force in the housing market and economy. Figure 2, which plots FHA's market share and GDP growth, demonstrates starkly this countercyclical role. When credit markets are booming and credit spreads are low, FHA's market share naturally shrinks. The funding advantage that FHA/GNMA has over the private market is much lower during good times. Furthermore, the administrative challenges of FHA lending are a disincentive to lender participation when there is ample private credit available.

Figure 2



During times of economic stress, however, private credit providers pull back as they eschew risk, and the share of FHA-insured lending grows. Then, as markets normalize and private lenders begin taking more risk and seeking greater returns, FHA market share falls again. As the recession moves further into the past, the FHA share will likely continue to fall. In the 1990s and early 2000s, FHA share typically ranged between 10 and 15 percent, but it fell to less than 5 percent in the years immediately preceding the crash. As of mid-2012, the share has settled back to around 15 percent.[10] Note that FHA policies tend to be relatively stable; it is the private sector that is either accelerating or decelerating.

Given the extent of the hardship Americans have endured in recent years, it is difficult to imagine that the economic downturn could have been more severe if not for the stabilizing role that FHA played. Consider a homeowner who finds her income limited and can no longer afford her mortgage, or needs to move to another part of the country to find work or care for a relative. If credit continues to flow, other purchasers can buy the home, allowing the homeowner to recapture her equity and/or downsize without destroying her credit. But if lending to all but borrowers with pristine credits and high downpayments disappears, the homebuyer cannot sell and the value of the home declines precipitously, leaving others in the neighborhood with lost equity. This outcome creates ripple effects throughout the community, ultimately affecting consumption and employment.

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[9] Alejandro Becerra, "The 2011 State of Hispanic Home Ownership Report", National Association of Hispanic Real Estate Professionals, March 2012.

[10] Ibid.

Economist Mark Zandi of Moody's estimates that, absent FHA-insured lending, home values might have fallen another 25 percent, resulting in 3 million more job losses and a reduction of economic output of $500 billion. [11] By this estimate, the value of the housing stock would have fallen in total by half, not the third that it did fall.

In addition to serving an indispensable countercyclical role for the housing market in times of crisis, FHA played on important part historically in standard setting and testing new underwriting. Before the creation of FHA, mortgages were relatively short-term loans with the principal due at the end of the term. FHA introduced the idea of a self-amortizing long-term mortgage. FHA mortgages initially had a 20-year term. Now 15-year and 30-year products are standard for both FHA and the market. More recently, FHA has worked to set standards around reverse mortgages. Going forward, as we gain insight on how credit counseling can reduce mortgage risk, how alternative credit histories like rent and utility payments help predict loan performance, and how the availability of reserves and repair escrows improve loan performance, FHA could again play a role in piloting new prudent underwriting standards to gain sufficient evidence under various conditions to attract private capital to measure and price the risk appropriately.

FHA-insured mortgages, along with mortgages backed by the Veterans Administration (VA) and the Rural Housing Service (RHS), form the basis of GNMA mortgage-backed securities (MBS). These securities are valued by the capital markets for their liquidity—that is, the ability to trade large volumes at a market price at low transaction costs. This liquidity is the product of the full faith and credit guarantee, the standardization of product, and the scale or size of the market. The result is a market with low transaction costs and transparent prices. This liquidity benefits not only the investor, but also the borrower through lower mortgage rates. One study suggested that interest rates fell by more than 50 basis points when GNMA securitization was introduced in the 1970s. [12]

The above discussion focused on FHA's role in the single-family mortgage market. FHA also plays a valuable role in the multifamily finance market. In this market, as well, FHA provides a countercyclical role, helps preserve housing units as affordable, and finances parts of the market that tend to be underserved, such as financing for apartments for low-income households.

Current State of FHA's MMI Fund

The important roles that FHA plays in the housing market and the larger economy described above entails taking risk. FHA tries to price for that risk accurately to absorb costs under most likely circumstances but, like most housing market participants, it rarely gets it just right.

Like most insurance, during good times, the excess of premiums collected over the cost of claims builds up in the FHA fund, creating a capital reserve. But, low downpayment mortgages will experience elevated defaults when house prices fall and unemployment rises. Given that we have seen the worst housing downturn since the Great Depression, we should not be surprised to see that defaults increased and the MMI Fund experienced significant outflows.

A few observations:

- The countercyclical nature of the FHA has helped. During most of the worst origination years in the market 2005 through 2008, FHA had relatively low volumes. Thus, although the performance of those books was poor, as it proved to be for most market participants, the absolute size of the losses was less than it would have been if the poor performing books of business were above average in size.
- The greatest net cost to the FHA Fund was at the pivot point—when private capital was fleeing the market and originators accustomed to generating lower-quality product looked for new outlets. Too much of that weak product ended up in FHA's portfolio before FHA could tighten its own standards. According to HUD reports, the worst years were 2007 and 2008:

> The (single-family) books-of-business insured prior to 2010 are expected to generate large losses for the MMI Fund. The peak book for losses per-dollar of insured loans is 2007, the year that also has experienced the greatest

[11] Jesse Eisenger, "New Target in Finger-Pointing Over Housing Bubble", *New York Times,* January 9, 2013. *http://dealbook.nytimes.com/2013/01/09/new-target-in-finger-pointing-over-housing-bubble/*

[12] Deborah G. Black, Kenneth D. Garbade, and William L. Silber, "The Impact of the GNMA Pass-Through Program on FHA Mortgage Costs", Papers and Proceedings of the Thirty-Ninth Annual Meeting of the American Finance Association 36, No. 2 (May 1981): 457–69.

total decline in home values. When that book is finally closed, its total cost is expected to exceed 11.3 percent of the initial dollar volume of loans insured. Though the 2008 book has a lower loss-per-dollar (7.7 percent), that book was three times as large as 2007, and therefore, has expected dollar losses that are more than twice those of 2007 book ($13.2 billion versus $6.4 billion).[13]

- As standards tightened across the industry and FHA tightened its own rules, while private lender competition for high-quality credit borrowers disappeared, the credit quality in FHA's book of business grew tremendously. So newer books of business start to have net economic value for FHA, allowing it to begin to rebuild its capital. By 2010, early defaults had dropped dramatically and premium income had grown, leaving actuaries to predict that the economic value of the post-2009 books of business would speed the replenishment of the FHA fund.
- This phenomenon is typical of many insurance markets: the new books following the collapse are replenishing the fund. This diversification across time is an important element of insurance markets where there is high correlation of outcomes within the pool, such as property and casualty insurance. As former FHA Commissioner John Weicher, now of the Hudson Institute, tells the story, this pattern is very similar to that which FHA experienced in 1980 to 1982.[14]
- The increase in loan limits mandated by Congress also appears to have helped FHA to replenish the Fund. At a time when private capital and the GSEs were accepting only pristine credit with high downpayments, higher LTV larger dollar loans for FHA appear to have strengthened the performance of the Fund.[15] As economic times improve and private capital returns, however, these non-mission-related, high-dollar insured loans should no longer flow into FHA's portfolio where they inflate the total amount of insurance exposure of the taxpayers, regardless of the economic value of those books of business.
- We learn (or relearn) from these periods that certain products and practices disproportionately contribute to loss. In general, reduced documentation, an abundance of second mortgages, and lax appraisals increase losses.
- In the case of FHA, seller-funded downpayment assistance (SFDPA) and other seller contributions had much the same effect as second mortgages, which, along with lax appraisals, increased defaults in the program. For example, cumulative to date claim rates on the 2005 originations are over 20 percent when there was assistance from nonprofits compared to a rate of 9 percent when there was no assistance.[16] The Actuary estimated that SFDPA loans reduced the economic net worth of the MMI Fund by $15 billion. If FHA had never insured any SFDPA loans, the last actuarial report would have still shown a positive economic value for the Fund.
- The Home Equity Conversion Mortgage (HECM) program—the FHA program that first pioneered the reverse mortgage—has proven to be another major source of loss for FHA. When Ginnie Mae designed a securitization vehicle for HECMs in 2008, the product took off, with many lenders originating loans that allowed borrowers to take large cash amounts out of home value at one time, leaving them with limited resources to pay property taxes and other ongoing expenses. A well designed HECM converts home equity into an annuity at reasonable rates for living expenses. Performance of HECMs is especially vulnerable to home value fluctuations. FHA has tightened these standards significantly, but its authority to make changes is limited, and the slow pace of the rulemaking process necessary to return the program to its intended purpose has left the door wide open with FHA continuing to incur losses as program changes make their way through the regulatory process.

[13] U.S. Department of Housing and Urban Development," Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund", Fiscal Year 2012, November 16, 2012, at 42–43.

[14] Presentation by John Weicher at the American Enterprise Institute, January 24, 2013, available at *http://www.aei.org/files/2013/01/24/-john-weicher-fha-presentation_110740723232.pdf.*

[15] U.S. Department of Housing and Urban Development, slidedeck on "Annual Report to Congress, Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund", November 16, 2012, available at *http://portal.hud.gov/hudportal/documents/huddoc?id=111912FHAActRevPolResp.pdf.*

[16] Ibid.

Three primary strategies exist to mitigate or manage mortgage risk and protect the taxpayer. They are (1) improving underwriting and quality control; (2) expanding loss mitigation efforts; and (3) adjusting mortgage insurance pricing and increasing revenue. FHA has taken steps in each of these areas and must continue to press forward with this agenda. Steps taken by FHA include:

1. *Improving underwriting and quality control:* In 2010, FHA eliminated seller-funded downpayment assistance loans. It also imposed a 90 percent LTV limit for borrowers with FICO scores below 580, thereby increasing required downpayments to avoid the most severe risk layering. They also improved lender and servicer performance standards through the development of a uniform seller-servicer contract. And FHA put in place "Neighborhood Watch"—an early warning system that, by comparing delinquency data for originators against others, allows them to identify and take action to bar from the program those lenders who are producing a disproportionate share of early defaulting loans. FHA seeks greater authority to see indemnification from many lenders as well.
2. *Expanding loss mitigation:* While the housing market is rebounding (it was reported this week that the Case-Shiller national composite house price index increased 7.3 percent for 2012), delinquencies will remain elevated for several more years with employment and wage growth weak and many homes still underwater. Thus, it is important for FHA to work aggressively to avoid claims and reduce the size of those that cannot be avoided. Loss mitigation is especially important in communities with a high concentration of delinquent loans because the spillover effects of foreclosures producing further house price declines will hit the Fund doubly hard. FHA has stepped up its loss mitigation efforts. It changed REO disposition processes, revised modification treatment to address better delinquent loans, and has created an alternative resolution process for negative-recovery loans. FHA also has made a major effort to sell defaulted notes to servicers who may be able to avoid foreclosures or get better recoveries, thus reducing losses to the Fund. It also started the Claim Without Conveyance program so that a lender, rather than foreclose and convey a property to FHA in order to submit an insurance claim, can sell the property directly and submit a claim to FHA without FHA ever taking title to the home. These practices allow FHA to take advantage of the superior ability of private servicers to manage REO efficiently and improve recoveries.
3. *Adjusting mortgage insurance pricing and increasing revenue:* HUD has raised fees in order to increase revenue and strengthen the economic value of the MMI Fund. Since 2009, it has increased the Mortgage Interest Premium four times. The Actuary estimates these changes produced more than $10 billion in additional economic value for the Fund.[17] There are limits, of course, to how much premiums can and should be increased to recover costs incurred from earlier books of business. There is an inherent unfairness to making current home purchasers pay too much more because insurance was underpriced in an earlier era. However, at a time of record low interest rates and still-limited competition from the private sector to serve most FHA borrowers, the market can bear higher prices without FHA being adversely selected.

While more can and needs to be done, much progress has already been made in addressing some of the remediable sources of recent losses.

New Tools for FHA To Act Quickly To Manage and Mitigate Risk

A key pattern emerges from looking at FHA's recent performance. When FHA incurred losses that it might have avoided—that is, those losses which were not fundamental to FHA's countercyclical role or the inevitable consequence of calamitous economic and housing market conditions—the losses stemmed from the slow pace of change at FHA and the ways in which a Government agency cannot typically act as quickly as a private company can to protect itself against risk.

Think about the steps taken by the capital market investors to reduce their exposure to mortgages quickly as the market meltdown began. Think about how financial institutions tightened underwriting standards virtually overnight and dropped products that were proving to be expensive as soon as the costs were understood. Officials at a wide range of institutions exposed to mortgage credit risk, even at the GSEs, were able to comparatively quickly take steps to stop the bleeding. But not so at FHA.

[17] Ibid.

For example, FHA officials have been asking Congress for legislative changes to reduce losses in key programs since 2010. If some of those provisions had been adopted sooner, some fraction of taxpayer losses would have been avoided. For example, Commissioner Galante testified 2 weeks ago before that House that, 3 years later, HUD is still awaiting authority to seek indemnification from direct endorsement lenders and the ability to quickly terminate a lender's ability to originate FHA insured loans.

Similarly, HUD has made far too little progress in implementing changes to the HECM program to better serve its intended purpose because they must complete an extremely slow and cumbersome rulemaking process. In general, in rulemakings about tightening criteria for FHA loan programs, there is little constituency for protecting the taxpayer from losses and enormous energy invested in the status quo from program participants. An eerily similar tale can be told about the seller-funded downpayment assistance loan program.

I do not wish to point fingers at Congress. These are extremely technical underwriting, loss mitigation, and pricing decisions that, to my mind, do not lend themselves well to legislative deliberation. Congress should provide a statutory framework, set appropriate goals and tolerance for risk, and provide effective oversight. My proposal would leave these essential legislative functions in Congress' hands.

- *"Risk management emergency powers: emergency authority to suspend issuing insurance under risky terms and conditions."* I propose a way to respond to this problem, create greater transparency, and ensure opportunity for effective congressional oversight. Congress should give the HUD secretary special emergency powers to suspend FHA insurance programs or make emergency modifications to the program when the secretary finds that continuation under current program terms exposes the taxpayers to "elevated risk of loss" and "fails to serve the public interest." Any such emergency action to terminate insurance would need to be accompanied by analyses of (1) the potential cost savings to the FHA Fund and the taxpayer risk that would be avoided; and (2) whether the program objectives established by Congress would be furthered or harmed by temporarily suspending insurance until program terms and conditions can be altered. The emergency authority proposed here would be time limited, requiring the HUD secretary to complete all appropriate administrative procedures to make the change permanent (or seek congressional authorization if a statutory mandate was involved). Congress could at any time vote to disapprove the use of the emergency powers by the secretary if they felt the risk was not properly assessed or the change was not necessary to meet public ends.

FHA has also faced difficulty in establishing early warning risk indicators and in taking steps quickly to stop specific originators from continuing to add loans to FHA's insurance portfolio which are markedly more likely than others to end in default. Commissioner Galante testified 2 weeks ago that HUD sought changes to the "statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance." Specifically, the secretary seeks to compare early defaults and claims by a range of factors including geography, underwriting, or populations served.

To my mind, the HUD secretary's request of Congress is too timid. It is in the public interest to empower the HUD secretary, who is overseeing a trillion dollars of taxpayer risk exposure, to use any early warning indicator that evidence suggests is predictive of losses, provided that its use does not discriminate or otherwise violate the law. When HUD officials know that taxpayers are being exposed to undue risk, it shocks the conscience to say that they must continue to accept such loans for insurance pending administrative procedures and overcoming burdens of proof. We should want FHA staff to be able to continuously refine its early warning indicators, be transparent about the risks that it is seeing, and take steps quickly to adopt new tools as they become available.

I do understand that the implementation of the FHA Compare Ratio, like any other early warning indicator, will potentially have unintended consequences that do not serve the public's interest. But it seems to me appropriate to shift the burden of proof, so that it is easier to protect taxpayers against risk and harder to continue to originate questionable loans for the FHA insurance portfolio.

- *Early warning risk indicators.* Congress should give the HUD secretary the authority to establish appropriate risk indicators on an ongoing basis and to use these indicators to limit access to participation in FHA insurance programs where these indicators suggest a lender, servicer, or other program participant is more likely to exposure the taxpayers to risk. When program participants can overcome a burden of proof that they do not pose undue risk or that a better

indicator is available, then FHA's decisions can be subject to scrutiny. But the goal should be to give the taxpayers—not program participants—the benefit of the doubt.

Another concern is that FHA tends to adopt new programs or program changes for its entire portfolio. There are exceptions, of course. FHA did begin to pilot note sales before expanding the program. But too often, unlike private-market participants that will try out a new business practice or insure a small portfolio and test performance before applying a strategy to the whole business, the statutory and regulatory environment for FHA leads to "all or nothing" policy changes. The length of the administrative procedures required also leads to full implementation rather than testing, because an evolutionary or phased change strategy would require iterative regulatory changes and sap so much administrative energy. These practices inherently increase risks to the Fund because new policies go into effect without enough evidence of their likely impact.

- Risk reduction pilots—authority to pilot new policies to test their costs and benefits before implementation. Congress should give FHA express authority to implement pilot programs quickly where the goal it so better understand, measure, and mitigate risk. Full implementation would follow normal administrative procedures. So, for example, FHA could test whether a new alternative underwriting standard (e.g., incentives for prepurchase counseling), or loss mitigation procedures, or REO disposition approach can achieve program objectives in a cost-effective manner.

Finally, an ongoing concern is whether FHA has the systems, technology, and analytical prowess to reengineer business practices to reduce risk, to understand emerging risks in their portfolio before it is too late, and so on. Giving the HUD secretary authority to hire for risk management, analytic, and technological systems staff on a more generous pay scale could close some of the gap between private-market participants and those charged with protecting the taxpayer from economic harm. Bank regulators are compensated slightly better than other Government officials so that the agencies can attract the talent with financial knowledge and analytic skills for effective financial regulation. And regulators can use funds assessed on those they regulate to support the operations, systems, and other needs of the agency to protect taxpayers from losses from insured depository institutions.

- Allow FHA to hire for select positions at elevated compensation levels to ensure that FHA can attract appropriate insurance, financial, and risk management skills. Also provide FHA with the ability to use insurance premiums for systems and analytical model acquisition to strengthen their capacity to mitigate risk.

Summary

Mr. Chairman, Senator Crapo, and Members of the Committee, it is clear that the health of FHA's MMI Fund has suffered because of losses resulting in part from problematic products and processes. Of course, rapidly falling house values due to a persistent economic recession and deep foreclosure crisis were the driving factor. Many of these losses were inevitable—and many result from FHA's critical role of ensuring credit flow and availability, which is particularly relevant during recessionary periods. However, it is also clear that better analytic capacity and management tools and the capacity to move more quickly to protect the taxpayer from losses could improve FHA's ability to manage, price, and mitigate risk and to, ultimately, protect the Fund.

FHA has taken important steps to stem losses where avoidable in outstanding books of business and to prevent insuring higher-risk loans going forward. They seek additional important authorities that would further strengthen the Fund. But those steps, to my mind, do not seem to fundamentally change the capacity of FHA to act quickly in the taxpayer's interest. Clear goals established by Congress, greater data transparency, and more authority to respond rapidly to changing conditions and new insights, to manage and mitigate risk, would go a long way to strengthening the Fund going forward and ensure that FHA does not again become so perilously close to requiring taxpayer support.

FHA's place in the housing finance system in the long term will depend on how policy makers resolve questions about the shape of the housing finance market and whether a limited, priced and paid for Government guarantee of high-quality mortgage-backed securities is available in a reformed system, after the demise of Fannie Mae and Freddie Mac in their current form. We must not take steps now, absent those larger discussions, that would make it impossible for FHA to continue to play its indispensible countercyclical role and its ever-important mission of ensuring credit is available to worthy borrowers who have limited options in the private mar-

ket. But we can seize this opportunity to strengthen FHA's risk management capacities immediately. For whatever role is assigned to FHA in the long term, we all will be better served if they have the capacity to manage better the risk they take on in fulfilling that mission.

Thank you.

PREPARED STATEMENT OF TERESA BRYCE BAZEMORE

PRESIDENT, RADIAN GUARANTY, INC.

FEBRUARY 28, 2013

Introduction

I am Teresa Bryce Bazemore, President of Radian Guaranty, Inc., a leading private mortgage (MI) insurance company. I am testifying today at the request of the Committee to discuss the mission and financial health of the Federal Housing Administration's (FHA) single family insurance program. In my testimony, I will address some of the key questions concerning the mortgage crisis and its impact on both FHA and the private MI industry and, as requested, suggest ways in which the FHA program can be improved.

Private MI is the private sector alternative to loans insured by FHA. Private MI, like FHA, helps qualified low downpayment borrowers to obtain an affordable mortgage. Both FHA and private mortgage insurers play an important role in making home ownership affordable and possible for millions of Americans.

FHA has been and remains a valuable part of the housing finance system. In the past few years, however, FHA has overtaken the mortgage insurance market due to increased loan limits, inadequately priced FHA premiums, and permissive FHA underwriting. The recent crisis has identified areas where FHA should improve its internal controls to ensure its continued ability to meet its mission without taxpayer cost. FHA has recently taken modest steps to scale back to its historical mission of supporting underserved borrowers, including modestly increasing premiums and strengthening underwriting requirements. These actions are positive steps in the right direction to improve FHA's financial condition and reduce taxpayer exposure; however, additional reforms, which I discuss in this testimony, are necessary.

It is also important to be mindful about other actions, such as increasing Fannie Mae and Freddie Mac (GSE) guarantee fees or imposing additional GSE "loan level price adjustments" (LLPAs), that make privately insured loans purchased by the GSEs more expensive than Government-backed FHA loans and steer borrowers to FHA instead of bringing more private sector capital into the housing market.

Additionally some regulatory proposals, like the proposed risk retention and Basel III rules, would provide FHA with a competitive advantage over private MI, and therefore, would tilt the playing field toward FHA loans and Government insurance and away from private MI.

Ultimately, housing policies should work to scale back FHA to its traditional mission of supporting underserved borrowers, while enabling private MI, with its reliance on private capital, to be used by borrowers in the conventional market.

The Role of Private MI

The private 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 downpayments. Today, about $900 billion in mortgage loans are currently insured by private MI.

Private MI has played an important role in providing first-time homebuyers with access to mortgage financing. Private mortgage insurers share this important role with FHA. The most recent National Association of Realtors (NAR) report on borrower profiles notes that 46 percent of first-time buyers had FHA financing while 33 percent obtained conventional financing. The GSEs are the key providers of conventional financing today, and private MIs are the GSEs' key providers of credit enhancement.

When a borrower places less than 20 percent down to purchase a home, the lender is required to obtain private MI in order for that loan to be eligible to be subsequently sold to the GSEs. Lenders are willing to make low downpayment loans, and the GSEs are willing to purchase them, because in the event of a homeowner's default on the mortgage, the private MI company pays the owner of the loan a specified amount of the unpaid mortgage. More specifically, the combination of the private MI coverage and the borrower's downpayment will typically cover 25–35 percent of the loan amount—meaning lenders and investors are at risk for only the remaining 65–75 percent of the loan amount. For example, if a borrower provides a

downpayment of 5 percent, a lender will typically require MI coverage sufficient to cover 30 percent of the loan amount such that the downpayment combined with the MI cover approximately 35 percent of the loan amount, leaving lenders and investors at risk for only 65 percent of the loan amount.

This practice of requiring private MI in an amount that is 25–35 percent of the loan reflects the GSEs' prudent determination that this amount of coverage has historically been necessary to cover costs associated with defaulted loans (interest charges during the delinquent period and during foreclosure, legal fees, home maintenance and repair costs, real estate brokers' fees, and closing costs) and any losses resulting from reselling the property for less than the outstanding mortgage loan balance.

Because the GSEs are now in conservatorship, once the loans are purchased by the GSEs, the Government—taxpayers—is now responsible for losses that result when borrowers default on those loans that are in excess of the amount covered by private MI. In other words, the claims paid by private mortgage insurers are used to reduce losses that would otherwise be paid by the taxpayer.

Indeed, over the past 4 years, private mortgage insurers have paid approximately $34 billion in claims resulting from foreclosure losses to the GSEs that would have otherwise been paid by taxpayers. Moreover, private mortgage insurers are projected to pay approximately $50 billion in total to cover losses from the recent, unprecedented housing downturn.

Importantly, placing the MI company's private capital at risk in a "first loss" position after the borrower means that both the mortgage insurer and the borrower have a vested interest in making home loans that are affordable not only at the time of purchase, but sustainable throughout the years of home ownership. Having their own capital at risk also means that mortgage insurers have very clear incentives to work with lenders, investors, and community groups to help borrowers in default stay in their homes.

The private MI industry has the resources to pay claims on existing loans and will continue to do so because of the rigorous, countercyclical capital and reserve requirements imposed by State insurance commissioners. Half of each premium dollar earned is required to go into a contingency reserve and generally cannot be touched by the mortgage insurer for 10 years. This ensures that significant capital reserves are accumulated during good times and then drawn upon to absorb losses during downturns.

Private MI companies also continue to insure new mortgages. Although capital limitations at a couple of private MI companies has meant that those companies are unable to write new business, the other private MI companies—including Radian—have increased the amount of loans we are insuring. The industry overall has more than enough capacity to insure the current and projected volume of low downpayment loans. In fact, the industry has attracted over $7 billion in new capital throughout the mortgage crisis, and new entrants to the industry have raised over $1 billion in capital since the crisis began. Looking ahead, private mortgage insurers stand ready to play a critical role in the future of housing finance by continuing to safely and soundly enable first-time and lower income families to obtain affordable and sustainable mortgage loans while protecting taxpayers from the losses that result from borrower default.

A Brief History of the Mortgage Crisis as It Affected Private MIs and FHA

As the housing bubble grew from 2000 to 2007, both FHA and private mortgage insurers found themselves at a disadvantage. Their efforts to promote responsible underwriting of mortgages for first-time homebuyers was undermined by the development of mortgage products the purpose of which was to avoid the use of ANY type of mortgage insurance—whether FHA insurance or private MI.

These mortgage products took several forms including piggyback loans where the borrower was given two mortgages (a first mortgage and a contemporaneous second mortgage) to cover the acquisition of a house with effectively zero cash downpayment or even a negative downpayment. The often advertised purpose of these loans was to avoid the payment of mortgage insurance by the borrower and—less advertised but just as important—to avoid the review of the borrower's ability to pay the mortgage(s) that was and is inherent in the use of Government or private mortgage insurance. In addition, private MI premiums were not yet tax deductible at that time while the higher interest paid on the second mortgage was tax deductible.

At the height of the boom, the new products that were developed were based on an assumption that house prices could only rise and consequently that, even if the borrower could no longer afford the mortgage, the worst that would happen would be that they would sell the house and the mortgage investor would be repaid in full at no cost to the entity securitizing the mortgage or to the taxpayer.

Both private MI companies and FHA were challenged by the expansion of these products. Indeed, at the height of the mortgage bubble, both FHA and Ginnie Mae expressed concern that the volume of new FHA loan originations was insufficient to maintain the liquidity of the Ginnie Mae market.

In order to remain in the market, the underwriting standards and pricing by both FHA and private mortgage insurers weakened. This weakening took the form of lower insurance premiums by both FHA and private mortgage insurers in an effort to compete against the uninsured high loan-to-value (LTV) mortgage products. The weakening also involved greater acceptance of the lenders' underwriting decisions, including the acceptance of low or no documentation loans by private mortgage insurers and the decisions generated through the automated underwriting systems employed by Fannie Mae and Freddie Mac. For FHA, the relaxed underwriting included the acceptance of seller paid downpayment contributions, as well as other underwriting changes.

As house prices began to fall, certain participants in the mortgage market were made aware of problems sooner than others. Lenders holding mortgages on their books saw the increase in delinquencies first and responded by tightening their proprietary underwriting requirements. To continue volume, however, they originated loans regardless of possible risk if these qualified for FHA or private MI. The GSEs and private mortgage insurers became aware of the higher rate of delinquencies later than the lenders and then tightened their underwriting standards and raised their premiums, but during the period when lenders shrank their piggy-back loan originations and other risky loan originations, private mortgage insurers were adversely selected. This "adverse selection" problem is among those proposed for regulatory reform in a recent paper on ways to improve both public and private mortgage insurance that was released earlier this year by the Joint Forum.

Beginning in 2007 and 2008, FHA saw a flood of new mortgage originations enter its books as lenders, the GSEs, and private mortgage insurers tightened their own underwriting requirements and raised their premiums and delivery fees. At the time this occurred, FHA had the lowest upfront insurance premium in its post-1990 reform history, and its annual premiums were set at a legislative minimum level. As a consequence, loans that otherwise would have gone to the subprime market or to the expanded approval, Alt-A, and other programs initiated by the GSEs instead were channeled by lenders to FHA. This adverse selection of FHA—a consequence of inadequate FHA premiums, delegated FHA underwriting to lenders, and the difficulty of a Government program to quickly respond to a changing mortgage market—resulted in FHA holding on its books a large share of subprime-like mortgages that were inadequately priced and poorly originated.

Private MIs and the Housing Downturn

The private MI share of the mortgage market contracted significantly as the crisis unfolded in 2008–2010. The entire industry faced higher claims requests as house prices fell and borrowers defaulted on their loans. Some private mortgage insurers stopped insuring new mortgages due to capital limitations. All private mortgage insurers were stressed by the significant nationwide house price collapse. But during this period of unprecedented stress to the private MI industry, private mortgage insurers continued to pay legitimate claims. From 2007 through the third quarter of 2012, the private MI industry had paid over $30 billion in cash claim payments and $3.6 billion in claim receivables to Fannie Mae and Freddie Mac alone as verified in their SEC filings.

Another factor contributing to the declining market share of privately insured mortgages in this time period were actions by Fannie Mae and Freddie Mac that made the loans that they purchased more expensive. After the GSEs entered conservatorship in the fall of 2008, they increased the fees they charged to purchase the high LTV loans of borrowers with moderate credit scores. The combination of higher GSE delivery fees, tighter GSE and private MI underwriting, and higher private MI premiums caused the private MI share of the insured low downpayment mortgage market to shrink significantly. Those actions by the GSEs, combined with higher FHA loan limits beginning in 2008, resulted in the private MI share of the insured low downpayment mortgage market that is served by FHA and private MI combined contracting from 77 percent in 2007 to 16 percent in 2010. [1]

FHA and the Housing Downturn

The delegated underwriting concept underlying the operations of FHA, combined with the 100 percent insurance coverage applicable to all FHA-insured loans, re-

[1] The remaining portion of the low downpayment market is insured by other entities such as the U.S. Department of Veterans Affairs (VA) and the U.S. Department of Agriculture.

sulted in a lack of information flowing to FHA as to the weakness in the market in general and the need to tighten its underwriting and appraisal requirements in particular.

FHA did not recognize the negative impact of declining house prices until 2010. It was then that FHA chose to increase its premiums. By then, its market share had increased from 17 percent in 2007 to 68 percent. By the time the FY2011 actuarial report was issued by the Department of Housing and Urban Development, the pre-2009 loans that had low premiums and lax underwriting accounted for 51 percent of FHA's insurance in force.

FHA has taken several steps to tighten its underwriting and raise its premiums in subsequent years. Whether these steps will be sufficient to offset the negative financial impact of FHA's rapid growth during a period of collapsing house prices has yet to be determined.

What is clear, however, is that FHA as a Government program provided access to credit for many low-downpayment borrowers as the housing crash unfolded. This is the role that a Government program should play during a period of economic contraction. Unfortunately, the structure of FHA as a 100 percent insured Government program that has delegated its underwriting to lenders has resulted in significant losses to the program.

Recommendations for the Future

The private MI industry has been gradually increasing its market share in recent years. Two new entrants to the private MI industry have together brought more than $1 billion in new capital and a third company—just announced last week—will be part of a well capitalized and well established multibillion dollar reinsurance company. Similarly, private MI companies with legacy books of business have taken steps both to raise capital and to reinsure their business in order to effectively bolster their capital position. In 2012, the private MI share of the insured low downpayment market increased from 26 percent in the first quarter to 35 percent in the fourth quarter.

However, FHA remains the dominant player in the low-downpayment market for several reasons, which continue to jeopardize the FHA's financial health and now act to restrain the growth of the private sector. Reforms are necessary to scale back FHA to its stated goal of returning to its historical mission of supporting underserved borrowers and improve the agency's financial position while enabling private MI, with its reliance on private capital, to be used by borrowers in the conventional market.

Share the risk with the private sector. Changes are needed both to protect the FHA and the U.S. taxpayer and, just as importantly, to protect future FHA borrowers who should not be put into homes they cannot afford to keep. FHA should be authorized to enter into a modern risk-share agreement with private mortgage insurers. Under this risk-share, the private mortgage insurer will conduct an independent underwriting of the FHA borrower and the mortgage being sought. If the borrower and the mortgage underwriting terms meet the conditions mutually agreed upon between FHA and the private mortgage insurer, then the private mortgage insurer will take the first loss on the FHA loan with the deeper loss covered by FHA. In this way, FHA and the U.S. taxpayer will be protected by an independent underwriting at the front end of the loan origination and private capital will be placed at a position of first loss risk on any future claim arising from the mutually insured loan. In this way the potential FHA borrower also will be protected by the upfront private MI underwriting from entering into a mortgage that places him or her at risk of foreclosure.

Focus FHA on low and moderate income borrowers. FHA's loan limits have been set at very high levels, which make the program attractive to borrowers with comparatively high incomes. In high cost areas, FHA insures mortgages up to $729,750. Even at interest rates as low as 3.5 percent, a borrower needs an annual income of no less than $175,000 to qualify for a loan of this size. Nationwide, the FHA has a base loan limit of $271,050, which is now almost $100,000 higher than the average existing home sold in 2012 according to NAR.

Additionally, the concept of a Government program targeted to house prices and loan amounts, rather than the income of the borrower, no longer makes sense. What we have seen over the years is that the FHA loan amounts continue to increase while the average American's income stagnates. Even when house prices fall in an area, the FHA loan limits remain frozen. Thus, through FHA, the U.S. taxpayer is being asked to subsidize larger and larger mortgages for those people who can afford them without taxpayer assistance.

In this time of budgetary struggles, asking taxpayers to subsidize higher income and wealthy borrowers through Government mortgage insurance seems like curious

public policy. Rather, the FHA program should be targeted to the median income of the household in an area. In fact, the Administration's February 2011 white paper to Congress on housing finance reform specifically called for limiting FHA eligibility to borrowers that have incomes below the median level for their area. In this way, FHA will be targeted to serve only the moderate and middle-income borrowers who need their help. FHA should not be used by higher income borrowers who can afford the highest priced homes in an area even where the average family in that same area could not dream of affording the same high-priced home.

Reduce the level of the Government guarantee. Congress should also reduce the FHA's guarantee below its current 100 percent level—similar to the VA mortgage program. An essential feature of private MI is the concept of coinsurance on the part of all parties to the transaction. Private MI stands in a first loss position behind the borrower's equity and generally is 25 percent to 35 percent of the loan amount, which covers most, but not all, of the losses that the parties to the mortgage transaction experience so there remains an incentive for all parties to avoid foreclosure. FHA, on the other hand, insures 100 percent of the loan amount if the home goes into foreclosure so that the loan originator lacks any meaningful risk of loss. This 100 percent guarantee does not properly align incentives between originators and the FHA. Reducing the 100 percent coverage amount will provide lenders with an incentive to conduct prudent underwriting. It will also reduce taxpayer exposure to losses resulting from borrower default, and this will reduce the budgetary cost of FHA's program.

Provide more flexibility for FHA premiums. One major reason FHA is in such financial distress is that it historically did not charge premiums that were appropriate for the risk. In order to adequately protect the FHA fund and the taxpayer and to avoid an unfair Government price advantage compared to the private sector, Congress should provide FHA with additional authority to adjust its premiums to levels that reflect the true risk of the loans that it insures. Doing so will help FHA to prevent another costly taxpayer bailout.

Avoid Government actions that unintentionally drive borrowers to FHA. It is important that the Government not take actions that unfairly tilt the playing field to Government insured programs like FHA rather than private MI, thereby discouraging reliance on private capital in the housing market. As policy makers scale back the GSEs, they also reduce opportunities for private MI, which means that low-downpayment loans will be insured by the FHA. For example, Fannie Mae and Freddie Mac, at the behest of Congress and the Federal Housing Finance Agency, continue to increase the fees that they charge to borrowers, such as GSE guarantee fees and LLPAs beyond what is actuarially sound, thereby making privately insured loans purchased by the GSEs more expensive than FHA-insured loans. As a result, increasing GSE pricing steers borrowers with low downpayments away from privately insured loans that are sold to Fannie Mae and Freddie Mac towards Government-backed FHA-insured loans. Policy makers should discontinue the practice of increasing GSE g-fees and LLPAs unless there is demonstrated additional risk, and GAO should publish and submit to Congress an annual, independent, actuarial review of GSE pricing.

Other Issues Facing the Mortgage Market That Congress Should Address

Finally, I would like to take this opportunity to draw Congress's attention to two important issues that will serve to impede the ability of low downpayment borrowers to obtain affordable and sustainable mortgage financing in the future unless the correct decisions are made by regulators.

QRM. First, regulators are today considering the appropriate mortgages to include within the Qualified Residential Mortgage (QRM) exemption to the Dodd-Frank risk retention requirements. The proposed rule would limit the QRM exemption to loans with 20 percent downpayments. Additionally, regulators have proposed to automatically exempt FHA-insured loans from the risk retention requirements.

As proposed, the rule would significantly and unnecessarily impede the availability of private capital to serve low-downpayment borrowers, and the U.S. taxpayer will be asked to bear even more of the risk associated with low downpayment borrowers.

Loans with downpayments of 5 percent to 20 percent that otherwise meet the standards of a Qualified Mortgage should be included within the QRM exemption provided that they have first loss loan level insurance coverage by an adequately capitalized mortgage insurer. In fact, a 5 percent downpayment loan insured by private MI has historically provided more protection to lenders and investors from the risk of default than would a 20 percent downpayment. This is because when adequate private MI coverage is required on a low downpayment mortgage, the combination of the private MI coverage and the borrower's downpayment will typically

cover 25–35 percent of the loan amount—meaning lenders and investors are at risk for only the remaining 65–75 percent of the loan amount instead of 80 percent for a loan with 20 percent down without private MI. Also, with the elimination of risky mortgage terms through the final Qualified Mortgage rule, the low downpayment borrower is protected from entering into a risky mortgage. With the addition of responsible and independent second underwriting by a mortgage insurer, both the borrower and the mortgage securitizer can be protected.

Basel III. Finally, the bank regulators have also proposed rules to implement Basel III in the United States. This Committee has rightly questioned the regulators about the adverse impact that the pending proposal will have on eligible borrowers and small banks. One of the most significant problems in the proposed rule is a unique proposal by U.S. banking regulators to not recognize private MI as a risk mitigant when assigning residential mortgage credit asset risk-weightings based on a mortgage's LTV ratio. This means that, as proposed, a loan with 5 percent down that is insured by private MI would be treated the same as a loan with a 95 percent LTV without private MI in terms of the amount of capital that a bank must hold for that loan. The final rule should continue the current treatment of private MI and permit banks to offset some of their capital with that of a qualified private MI, as this will significantly increase credit availability for first-time buyers without putting either the bank or taxpayer at risk.

Conclusion

FHA has served and should continue to serve a critical role in the housing finance system by providing access to home ownership to those low and moderate income borrowers who are unable to obtain loans via the conventional market. However, the recent crisis has identified issues that should be addressed in order for FHA to continue to play this important role. For example, in the report it released this week, the Bipartisan Policy Center recommended that Congress lower FHA loan limits and increase FHA premiums to return FHA to its traditional role. Indeed, FHA reform should be undertaken with a view toward reducing the role of the Federal Government in the mortgage market, increasing the role of private sector capital, and preventing future taxpayer bailouts. This necessarily includes scaling back FHA to its traditional role of supporting underserved borrowers and taking steps to improve the agency's financial position.

In examining the range of reforms before the Committee, I urge you to:

- Authorize risk-sharing between private MIs and FHA. This will introduce private-sector discipline to FHA underwriting and place private capital in a first loss position ahead of the taxpayer;
- Alter FHA-borrower eligibility standards to target them to low- to moderate-income levels as was recommended in the Administration's February 2011 white paper on housing finance reform, not house prices. This will allocate taxpayer resources to serve the FHA's rightful mission;
- Consider additional reforms, including reducing the FHA's guarantee below its current 100 percent level, much the same as the VA mortgage program. This will properly align incentives between originators and the FHA;
- Require FHA to establish premiums that accurately reflect the true risk of the loans that it insures. This will help to ensure that FHA avoids a costly taxpayer bailout;
- Avoid Government actions, such as GSE price increases, that steer borrowers with low downpayments away from privately insured loans purchased by the GSEs and toward federally insured FHA loans. This will bring more private capital into the housing market; and
- Encourage regulators to provide parity for private MI and the FHA in pending rules, including the QRM and Basel III.

PREPARED STATEMENT OF DAVID H. STEVENS

PRESIDENT AND CHIEF EXECUTIVE OFFICER, MORTGAGE BANKERS ASSOCIATION

FEBRUARY 28, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA) on the recent release of the Federal Housing Administration's (FHA) Fiscal Year (FY) 2012 Actuarial Review, and its findings on the state of the Mutual Mortgage Insurance (MMI) Fund.

My name is David H. Stevens, and I am the President and CEO of the MBA. From 2009 to 2011, I served as Assistant Secretary for Housing and FHA Commissioner at the U.S. Department of Housing and Urban Development (HUD). Thank you for holding this hearing on the actuarial soundness of FHA's single-family insurance fund.

Given that professional experience, and my almost 30 years in real estate finance, I understand the importance of having a strong, capable leader to navigate the agency through this difficult time in FHA's history. I commend the Senate for confirming Carol Galante as FHA Commissioner at year's end. Commissioner Galante has been a staunch advocate for housing throughout her career, and I know she will work tirelessly to protect taxpayers and return FHA to sound financial footing. The changes she has announced to date provide comfort that the agency is moving aggressively and in the right direction.

FHA made headlines at the end of 2012 following the revelation that its MMI Fund, which holds the accounts for the single-family programs, had a negative capital ratio. Conversely, FHA's multifamily rental and healthcare programs, which are supported by HUD's General and Special Risk Insurance Fund, are fiscally sound. The Actuarial Review of the FHA MMI Fund Forward Loans for Fiscal Year 2012, released by HUD on November 16, 2012, confirmed that FHA, like most participants in the mortgage market, is still dealing with fallout from the recent housing crisis. FHA's problems may be exacerbated by its traditional countercyclical role and programmatic focus on underserved, minority and first-time homebuyers who may not be able to meet the downpayment or household wealth requirements for private loans.

MBA firmly believes that FHA has a vital role in the United States' housing finance system and its mission of serving first-time homebuyers and underserved populations and playing a countercyclical role should continue. Since its inception in 1934, FHA has enabled more than 40 million families to become homeowners.[1] In FY2012, 77 percent of FHA purchase endorsements were to first-time homebuyers and 33 percent were to minority homebuyers. According to HMDA data, in 2011, 56 percent of African American homebuyers, and almost 59 percent of Hispanic homebuyers financed their purchases with FHA loans.[2] In 2012, applications for Government refinance loans (primarily FHA) were almost 15 percent of all refinance applications, while applications for Government loans to purchase a home were 37 percent of all purchase applications.[3] Thus, recent data confirm that FHA continues to play an especially critical role in providing home ownership opportunities.

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

FHA and Its Role in the Housing Market

FHA has played an important countercyclical role in the mortgage markets, both historically and in the most recent housing downturn. As private market credit risk appetites grew during the precrisis years, FHA began to lose market share. FHA's market share significantly declined during the early 2000s, a period when the private market was experiencing significant growth due to alternative mortgage products and a rise in demand for private label mortgage-backed securities.

Many of FHA's traditional borrowers—low-wealth families with minimal funds for a downpayment—left FHA during the housing boom for subprime and other loans that provided lower initial monthly payments. As the housing markets heated up, FHA's fully documented underwriting was perceived as overly onerous and bureaucratic. From 2003 until 2007, FHA's share of the mortgage market hovered between 2 and 7 percent.[4] Its flagship 30-year fixed-rate mortgage was shunned by many

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

[2] MBA analysis of 2011 HMDA data.

[3] Data compiled from MBA Weekly Applications Surveys.

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

borrowers looking for lower initial mortgage payments. In addition to FHA's more stringent underwriting standards, there was a general belief by many market participants, lenders and borrowers alike, that FHA-insured loans were too time-consuming, expensive, and complicated compared to conventional or subprime loans. As a result, FHA was not the first choice for many real estate borrowers, brokers, and lenders.

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

As the housing market began to tumble in 2007, the private label market contracted precipitously and lenders began to shift as much production as possible to FHA, Fannie Mae, and Freddie Mac. The Economic Stimulus Act of 2008 increased both conventional and FHA loan limits throughout the country and especially in high-cost areas. Approximately 75 of the highest cost counties in the Nation saw the FHA loan limits more than double from $362,790 to $729,750. Another 500 counties had new loan limits set between $280,000 and $729,750. The remaining 2,500 counties had new loan limits of $280,000, up from $200,000. The once dormant FHA experienced high demand from coast to coast.[7] At the height of the housing crisis in 2009 Government loans accounted for over 40 percent of the purchase market compared to 34 percent today.[8] Most of these loans were FHA-insured. Performing this countercyclical role, however, has proven costly for FHA as its postcrisis books-of-business, 2008 and 2009 vintage loans, continue to show very significant losses, as reflected in the FY2012 Actuarial Review.

FY2012 Actuarial Review

The Actuarial Review provides an annual assessment of the fiscal health of the FHA and its financial outlook at a particular point in time. The FY2012 Review showed that the capital ratio of the MMI Fund had fallen to negative 1.44 percent, well below its statutory 2 percent requirement. In the FY2011 Review, the ratio was 0.24 percent, and the ratio for the prior 2 years had been below the statutory 2 percent minimum as well. The news that the capital ratio had turned negative prompted immediate concerns that FHA might need a draw from the U.S. Treasury (Treasury)—the first in the agency's history—and called into sharp focus whether FHA's policies need to be adjusted.

Highlights of the Actuarial Review include:

- The negative 1.44 percent ratio represents a negative economic value of $16.3 billion. This is the first time the Fund has been negative since the early 1990s.
- The economic value indicates the amount of resources the fund has over and above the reserve held for expected losses.
- The Actuarial Review cites several important reasons for the decline in the capital reserve ratio, including:
  - A less optimistic House Price Appreciation (HPA) forecast since last year ($10.5 billion reduction).
  - Lower historic and projected path for interest rates ($8 billion reduction). More borrowers are projected to pay off their mortgages, which reduces future revenues on the current portfolio.
  - Refinements to the forecasting model ($10 billion on the forward mortgage portfolio; $3 billion on HECM loans). Following recommendations by the GAO, HUD's Inspector General, and others, the actuary changed the way it calculates losses on defaulted loans. This change in methodology resulted in

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

[6] Ibid at p. 25.

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

[8] Data compiled from MBA Weekly Applications Surveys.

an estimated $13 billion in reduced economic value compared to last year's projections. Previous models did not adequately model the differential loss severities of preforeclosure sales (short sales) versus conveyances (REO sales). In particular, last year's model did not apply large enough loss severities for very high LTV loans. This year's Review takes a more comprehensive approach towards the modeling of previously modified loans.

- The total capital resources of the Fund at the end of FY2012 were estimated to be $30.4 billion.
- The Actuarial Review finds that there is a 5 percent chance over the next few years that capital resources will go negative.
- Focusing on the forward portfolio, as of the end of FY2012, the Fund is projected to have an estimated economic value of negative $13.48 billion, an unamortized Insurance-in-Force (IIF) of $1,126.27 billion and amortized IIF of $1,053.33 billion.
- The economic value of the 2007–2009 books of business is negative 7 percent while the economic value of the 2010–2012 books of business is positive 3 percent.
- The FY2012 book of business is projected to contribute an estimated $11.92 billion in present value to the economic value of the Fund.
- The economic value is projected to increase over the next 7 years to reach $54.25 billion by the end of FY2019. However, this estimate is subject to assumptions regarding the volume and composition of future books of business.
- HUD also reports that the Home Equity Conversion Mortgage (HECM), FHA's reverse mortgage program, portfolio has a negative economic value, negative 3.5 percent. Adding the economic value of the forward mortgage and HECM program produces a total economic value of negative $16.3 billion.

Importantly, these findings do not mean that FHA has insufficient cash to pay insurance claims, a current operating deficit, or will need to immediately draw funds from Treasury. Indeed, the Actuarial Review itself does not determine if FHA needs a draw from Treasury; that need is determined by the economic assumptions used in the President's FY2014 budget proposal. The final determination on a potential draw will be made in September 2013.

Given that the country just went through a severe recession from which it is still recovering, it is not surprising that FHA is experiencing significant losses on loans made during the crisis, as well as losses on the large volume of new business. High unemployment, steep home price declines and the seller-funded downpayment assistance program loans weighed heavily on the MMI Fund. The Actuarial Review estimates that the forward loan portfolio in MMI Fund may not be positive until 2014, and will reach the statutory 2 percent threshold some time in FY2017; the HECM portfolio is not projected to be positive within the timeframe of the Actuarial Review.[9]

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

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

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

Importantly, FHA's capital adequacy requirements are designed to be analogous to those for private institutions—they minimize the likelihood that taxpayers would need to provide funds to FHA. For a private sector financial institution, regulatory capital measures are a key indicator of financial health. Banks and other financial

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

institutions set aside reserves to cover expected losses on lending, but also hold capital to cover unexpected losses that may arise from changes in economic or financial market conditions or loan performance. Regulators require financial institutions to hold sufficient capital to minimize the likelihood that they would become insolvent during a crisis. FHA's requirements are modeled after these sound and proven practices, although, clearly the recent crisis has taken a severe toll on the FHA's financial stability which may require additional programmatic changes.

National Delinquency Survey Recap From Fourth Quarter 2012

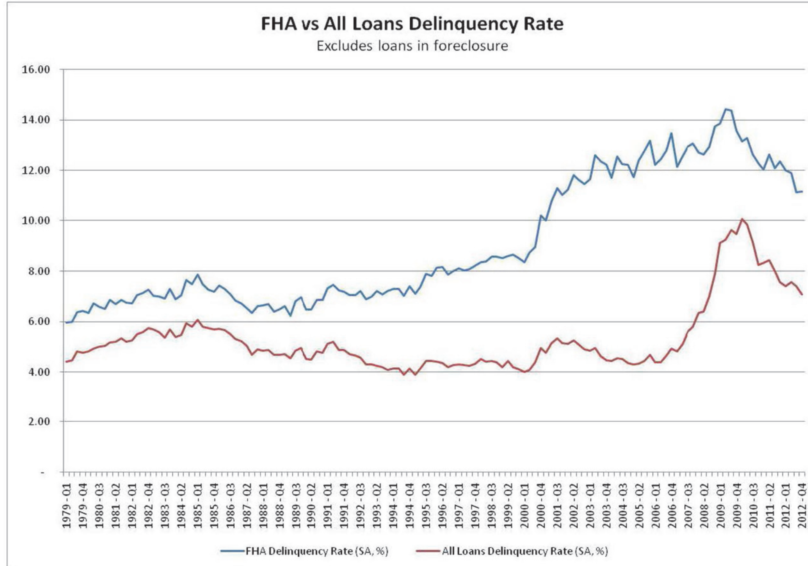
On February 21, 2013, MBA released its fourth quarter 2012 National Delinquency Survey (NDS) results. There were large improvements in mortgage performance nationally and in almost every State. The 30-day delinquency rate decreased 21 basis points to its lowest level since mid-2007. With fewer new delinquencies,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

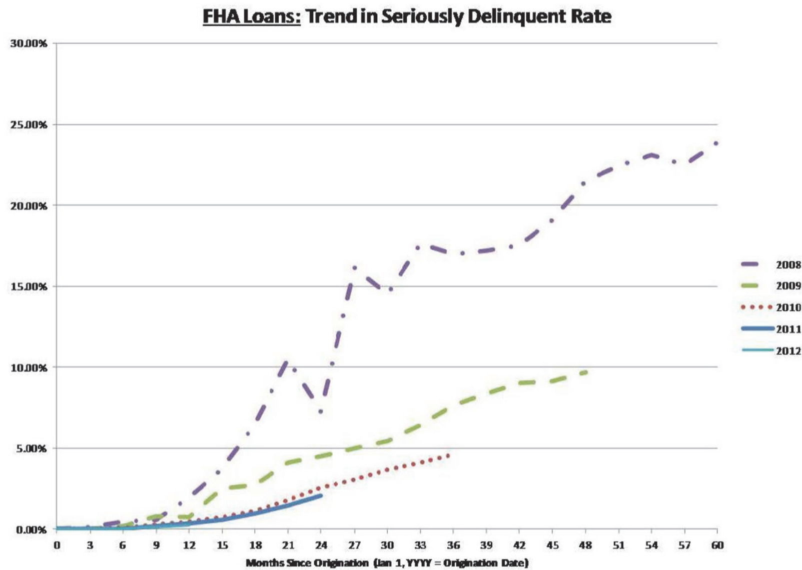
The foreclosure starts rate decreased by the largest amount ever in the MBA survey and now stands at half of its peak in 2009. Similarly, the 33 basis point drop in the foreclosure inventory rate is also the largest in the history of the survey. One cautionary note is that the 90+ delinquency rate increased by eight basis points, reversing a fairly steady pattern of decline and the largest increase in this rate in 3 years. While we normally see an increase in this rate in individual States when they change their foreclosure laws, 38 States had increases in the percentage of loans three payments or more past due, indicating that we could see a modest increase in foreclosure starts in subsequent quarters.

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

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

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





Recent FHA Policy Changes

FHA has made a series of single-family risk management and lender oversight and enforcement changes over the last 2 years, such as raising the annual mortgage insurance premium several times, increasing downpayment requirements from 3.5 percent to 10 percent for borrowers with credit scores below 580, eliminating FHA's approval of loan correspondents, raising lender net worth requirements in all programs, reexamining HECM policies, and establishing the Office of Risk Management. By making these changes, FHA has taken substantive steps over a short period of time to protect the Fund. The credit profile and performance of the FY2010

to 2012 portfolios are testaments to these changes: the average FHA credit score for FY2011 was 696[10] and the delinquency rate was 2.07 percent in the fourth quarter of 2012.[11] Significant performance improvement in the Fund is especially notable in the 2010, 2011, and 2012 books of business.

More recently, in response to the FY2012 Actuarial Review, FHA announced a series of program changes aimed at increasing revenue, reducing credit risk, and improving the management of the existing portfolio. MBA believes that these recent changes are fiscally prudent and warranted given the financial realities described in the Actuarial Review. In late January 2013, FHA announced the following administrative changes directly aimed at either increasing revenue or reducing credit risk:

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

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

Policy Considerations

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

1. Restoring financial solvency;
2. Preserving the housing mission; and
3. Maintaining its countercyclical role.

Congress and this Administration face the challenge of striking a balance among these three goals. MBA is currently working with its members to evaluate the pros and cons of various policy options to determine which ones offer the greatest impact while meeting the aforementioned goals. These trade-offs are outlined in MBA's soon to be released white paper. Below are selected considerations from our findings.

Reducing or Eliminating Risk Layering

In underwriting borrowers, individual risk factors can sometimes be mitigated by compensating factors. FHA's traditional underwriting philosophy takes this approach. The key to further improving the credit quality of the portfolio going forward is to limit excessive risk layering. Doing so could make future FHA business even stronger than the 2010–2012 books. Congress and the Administration, however, need to recognize that while the losses in the 2008 and 2009 books can be reduced and managed through better default management execution at FHA, changing credit standards on future books will not lower these embedded losses, and may actually harm the housing market recovery.

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

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

[11] *See,* Chart on page 7.

Downpayment Requirement

A risk management method that FHA has already begun to employ is to tier downpayment with credit scores and possibly other loan characteristics. Increasing FHA's minimum downpayment requirement would immediately improve FHA's risk profile on new business. An increase of the minimum downpayment from 3.5 percent to 5 percent would reduce expected losses to the MMI Fund through lower default rates and lower loss severity in the event of default. This step would increase the economic value of future books of business, but obviously would do nothing to reduce losses already on the books. It should be noted that the Government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, price differently based on LTVs. For example, Fannie Mae charges an additional loan level price adjustment of 50 basis points for loans with LTVs between 95 and 97 percent.

FHA has made similar policy changes that increase minimum downpayments for certain borrowers. A borrower with a credit score below 580 is required to have a 10 percent downpayment. Additionally, HUD has proposed raising the minimum downpayment for borrowers with loans above $625,500 to five percent.

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

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

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

Credit Score Floor

In response to the FY2012 Actuarial Review, FHA is requiring borrowers with credit scores below 620 to have a maximum debt-to-income ratio no greater than 43 percent in order for their loan applications to be approved through FHA's TOTAL Scorecard, an automated system used by FHA-approved lenders to score the quality of an FHA loan application.[12] Borrowers with credit scores and DTI ratios that do not meet these requirements may still obtain an FHA-insured loan, but their loan application must be manually underwritten by the lender to ensure adequate compensating factors.

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

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

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

Reserve and Debt-to-Income Requirements

Tightening FHA's credit box to require 2 month reserves and DTI requirements for all borrowers would promote even stronger performance than that seen in recent books. Reserves and DTI requirements for all borrowers would help homeowners absorb major household expenses, such as replacing a heating system or paying for a car repair. These changes would positively impact FHA's default rate and should reduce future claims. Moreover, this would be another way to verify if borrowers are truly financially prepared for the cost of home ownership.

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

High-Cost Loan Limits

In 2011, Congress extended the high-cost loan limits first enacted in the Economic Stimulus Act of 2008, thereby maintaining the FHA high-cost loan limit of $729,750 until December 31, 2013. Importantly, this loan limit was only extended for FHA-insured loans; the GSE loan limit was lowered to $625,500. According to MBA data, less than 1 percent of FHA-insured loans are between $625,500 and $729,750. FHA lending above $625,500 is most prevalent in the following areas: Washington, DC (12.9 percent); California (3.4 percent); Virginia (3.2 percent); and New York (3.1 percent).[13]

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

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

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

While it would be rational to lower the high-cost FHA limits to focus the program on lower-income and lower-wealth borrowers, the question is when to make this change. It is also important to recognize that making this change is unlikely to contribute positively to the financial health of the Fund, but would primarily serve to refocus FHA on serving its core mission.

Lender Enforcement

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

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

According to HUD, heightened enforcement of its requirements for FHA-approved lenders has resulted in over 1,600 lenders being withdrawn from FHA's program as a result of violations of FHA approval, origination, or servicing requirements and

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[13] Data compiled from MBA Weekly Applications Surveys.

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

[15] Mortgagee Letter 2010-02.

[16] Mortgagee Letter 2010-03.

[17] 24 CFR Part 203.

the imposition of more than $13.8 million in civil money penalties and administrative payments for FHA-approved lenders.[18]

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

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

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

When lenders must operate their businesses to near-perfect standards or potentially face substantial financial penalties, they will naturally restrict their underwriting to be well within the boundaries of cautious lending. Thus, overlays that include higher credit scores, lower debt-to-income ratios, and reserve requirements—all above and beyond the official FHA program guidelines—become necessary buffers to mitigate lender risk. This response from lenders directly impacts consumers by eliminating borrowers who could possibly be responsible homeowners, but have a few risk factors. Given the high stakes of indemnification or lawsuits, it is difficult for lenders to justify taking a chance on marginal borrowers—FHA's targeted population.

Let me be clear: as FHA commissioner, I initiated tighter controls and enforcement procedures that shut down irresponsible FHA lenders. When warranted, this is the right thing to do for the Fund and the market. Dishonest or sloppy lenders have no place within the FHA program. However, FHA must take a balanced approach to enforcement; otherwise FHA's practices could risk lenders cutting off credit that is needed to help support the housing market recovery.

MBA unquestionably supports high standards for all lenders that participate in FHA programs in order to protect the agency's viability, the lender's reputation, and the reputation of the industry. MBA members recognize and accept accountability for instances of fraud and negligence within their control. Moreover, lenders take full responsibility for underwriting mistakes that lead to loan delinquencies and incorporate sophisticated quality control systems to minimize the possibility of indemnifications. There must, however, be a reasonable margin for human error, especially when the error is not the cause of the delinquency or default. MBA would staunchly oppose efforts that allow FHA to go beyond reasonable standards of lender enforcement.

Servicing Loss Mitigation

FHA has taken proactive, appropriate, and aggressive steps to manage its 2000 to 2009 books-of-business, which include the agency's most costly loans. MBA commends these efforts, given that FHA already holds the risk on the loans. MBA also recognizes that additional steps may be necessary to further minimize losses. Below are MBA's thoughts on various means FHA is judiciously employing or considering to further reduce losses.

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[18] U.S. Dept. of Housing and Urban Development, "Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund" (November 2012), at p. 61. Can be accessed at: *http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf.*

[19] Schulman, P.L., Baugher, K.M. (2012), "Triple Trouble", *Mortgage Banking,* 72 (10), pp. 61–62.

Launch Large-Scale Proactive Modification and Partial Claim Campaigns for Delinquent Borrowers

During recent years, HUD has promoted several programs to assist borrowers retain home ownership, including the introduction of FHA's Home Affordable Modification Program (HAMP), which help homeowners experiencing financial hardship make their homes more affordable by reducing the mortgage payment. Recently HUD made revisions to its loss mitigation home retention options making it easier for borrowers to qualify for FHA HAMP partial claims [20] and modifications.

Enhancing loan modifications and partial claims have the potential to achieve HUD's objective of helping more delinquent borrowers return to performing status on their mortgages and ultimately reducing losses from foreclosures. MBA is encouraged that this effort will yield positive results and truly make a difference for many borrowers.

MBA does recognize, however, that increasing the number of partial claims in the short-term will require more cash outlays from the MMI Fund. Unsuccessful partial claims are costly to the MMI Fund because they prolong the existence of nonperforming loans and increase claim obligations, deterioration of the property and other liabilities. However, MBA anticipates that the increase in partial claims and other loss mitigation solutions will result in long-term savings for HUD.

Encourage Preforeclosure Sales

A preforeclosure sale (PFS) is a "short sale"—a sale of the property in satisfaction of a defaulted mortgage even though the proceeds are less than the amount owed on the mortgage.

HUD has acknowledged that preforeclosure sales are beneficial in the economic recovery, as well as a cost-savings for HUD. For these reasons, HUD plans to take steps to encourage more preforeclosure sales as an alternative to foreclosure.

Preforeclosure sales allow homeowners a quick resolution of a mortgage loan in default without experiencing the foreclosure process. HUD benefits by avoiding long foreclosure and eviction periods during which debenture interest and claim expenses accumulate and when property damage can occur.

Modifying the rules on preforeclosure sales will allow borrowers who cannot and do not want to retain their homes dispose of them more quickly. However, modifying the rules also may increase strategic defaults by borrowers who are capable of repaying their debts. Such a result would increase overall losses for FHA. With proper controls, however, this risk can be minimized.

Enhance Servicer Performance Management and Oversight

HUD is in the process of implementing an enhanced servicer performance scorecard that we understand will include the following four core areas: (i) foreclosure prevention; (ii) loss mitigation engagement; (iii) single-family default monitoring system (SFDMS) reporting; and (iv) redefaults. It is expected that the new scorecard will become the vehicle to determine loss mitigation incentives and treble damages for failing to engage in loss mitigation. Changes to the scorecard will require rulemaking and *Federal Register* notice and comment before they become effective. In addition, HUD will issue a Mortgagee Letter with further details.

The new scorecard changes how performance is measured, and will likely reduce HUD outlays of loss mitigation incentive payments for execution of loss mitigation and could increase the imposition of treble damages. This will affect servicers, which depend on loss mitigation incentives to cover the enhanced servicing obligations imposed on them to administer delinquent FHA borrowers. Also, we are concerned the new scorecard will provide, for the first time, a vehicle to impose treble damages for reporting issues and issues outside of the servicer's controls (such as redefaults) rather than on servicers' efforts to offer loss mitigation. We do not believe treble damages are the appropriate remedy in these cases. The changes will result in the need for additional overlays in origination to reduce the risk of default, which in turn will reduce originations to FHA.

Accelerate Note Sales

As part of the effort to address the housing market's "shadow inventory" and to target relief to communities with high foreclosure activity, HUD has accelerated the use of note sales through the Distressed Asset Stabilization Program (DASP). This program enables HUD to sell severely delinquent loans insured by the FHA through

[20] Under the Partial Claim Option, the Lender will advance funds on behalf of the Borrower in an amount necessary to reinstate the delinquent loan. The Borrower will execute a Promissory Note and Subordinate Mortgage payable to HUD. Currently, these Promissory or "Partial Claim" Notes assess no interest and are not due and payable until the Borrower either pays off the first mortgage or no longer owns the property.

a competitive bidding process in which loans are sold to the highest bidder, including nonprofit and community-based organizations.

HUD benefits from the program because it does not have the expense of an extended foreclosure process, saving considerable money for FHA's insurance fund. Borrowers benefit because the new note holders may have additional flexibilities to modify loans that FHA servicers do not have.

Home Equity Conversion Mortgage (HECM) Program

The independent actuary projects the economic value of the HECM (reverse mortgage) portfolio to be negative $2.8 billion, compared to $1.4 billion in FY2011.The major reasons for this steep decline are:

- Updated mortality and termination speeds. Expected termination rates are slower than projected last year, thereby reducing the economic value by $1.9 billion. Survivorship beyond 10 years results in a greater chance of loan balances exceeding property values and HUD realizing a loss.
- Higher rate of property conveyance at termination. Presently, about 70 percent of nonrefinance loan terminations result in the conveyance of properties to HUD compared to about 70 percent of property sales being handled directly by owners or real estate executers historically. The new actuarial estimates use updated projection model rates based on this new reality. The change reduces the value of the Fund by $1.9 billion.
- Less optimistic baseline house appreciation rates. As discussed in the FY MMI Actuarial section, home price appreciations have been revised since the FY2011 Actuarial Review. [21]

In response to the actuary findings, HUD has announced significant changes to the HECM program. Effective April 1, 2013, FHA consolidated the Fixed Rate Standard program with the HECM Saver product, thus reducing the maximum amount of funds available to the borrower. [22] The Fixed Rate Standard was attractive to borrowers because it allowed borrowers to maintain a fixed rate and withdraw the maximum amount of proceeds at loan closing. The HECM Saver allows the borrower to continue to have the predictability of a fixed-rate with lower upfront costs, but the borrower is not able to draw as much funds as the Fixed Rate Standard.

MBA continues to support the HECM program and the association applauds FHA for devising a solution to immediately address problems with the HECM program but still allow seniors to have viable reverse mortgage options. As the population ages and seniors recover from the recent economic downturn, HECMs are an important option for this population. Although only a few years old, the HECM Saver is proving to be cost effective for borrowers and financially prudent for FHA. FHA is appropriately continuing to develop ways to better manage the program and ensure its sustainability, such as how to deal with taxes and insurance defaults. As Congress considers legislative action to improve the HECM program, we would urge you to consider the ramifications of restricting the program to such a degree that it will not serve its purpose of providing financial options to this important, and growing, population.

Potential Impact on FHA From Other Regulatory Initiatives

Potential changes to FHA cannot be viewed in a vacuum. Over the last 5 years, following the mortgage crisis, a host of major rules are in the process of changing the face of mortgage finance. Many of these changes are welcome and overdue, while others are concerning. All will permeate the financial system and FHA. And as these changes come on line, their impacts must be carefully assessed through the prism of how they will serve consumers and the Nation. Three major rules deserve particular attention.

FHA Qualified Mortgage

The Dodd-Frank Wall Street Reform and Consumer Protection Act required the Consumer Financial Protection Bureau (CFPB) to issue rules implementing the law's "Ability to Repay" provisions and defining a class of "qualified mortgages" (QM) that would receive enhanced legal protection from lawsuits. The law further authorizes HUD, the U.S. Department of Veterans Affairs, and the U.S. Department of Agriculture, in consultation with the CFPB, to prescribe rules defining types of

[21] U.S. Dept. of Housing and Urban Development, "Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund" (November 2012), at p. 50. Can be accessed at: *http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf*

[22] Mortgagee Letter 2013-01.

loans they insure, guarantee, or administer that are QM loans, which may revise, add to, or subtract from the CFPB's definition. FHA loans comprise approximately 30 percent of today's mortgage market. For several reasons, MBA has strongly urged the CFPB to eliminate the distinction between FHA QM safe harbor and FHA QM rebuttable presumption loans or at least raise the APR threshold to better define FHA QM safe harbor loans.

The CFPB's final rule makes clear that the bifurcation between QM safe harbor loans and QM rebuttable presumption loans is intended to provide greater recourse to subprime borrowers. FHA loans, however, are not "subprime." They are subject to Government oversight and significant regulation. FHA loans are generally fixed rate and adjustable loans are subject to extremely tight adjustment limits to protect borrowers. All loans must be fully documented, meet minimum downpayment and other requirements, and loans with credit scores under 620 now must also meet DTI requirements. Given the parameters of the FHA program and its regulation of all aspects of the process, MBA believes its borrowers are already well protected. Establishing a cutoff for FHA safe harbor loans will only add regulatory burden without providing any offsetting benefit.

MBA strongly believes that for the foreseeable future lenders will be extremely wary of originating loans that fall outside of the QM safe harbor. Consequently, if the threshold is not at least expanded, the availability of FHA credit for underserved populations—first-time, minority, and low- and moderate-income borrowers—may be unduly limited, jeopardizing FHA's ability to fulfill its important role.

Qualified Residential Mortgage

Another outstanding issue that will have a profound impact on FHA is the proposed risk retention rule. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires mortgage securitizers to retain 5 percent of the credit risk unless the mortgage is a Qualified Residential Mortgage (QRM). The proposed rule issued by six Federal regulators nearly 18 months ago would require families to make a 20 percent downpayment and meet relatively low DTI and other stringent requirements. It is not at all clear from the proposal whether the regulators reflected on the relationship between the proposed QRM definition and the FHA's eligibility requirements in light of FHA's statutory exemption from risk retention. The proposed QRM definition appears to conflict directly with the Administration's plan for reforming the housing finance system because it would make it far more difficult for private capital to reenter the housing finance market. In its white paper, the Administration made clear that it intends to shrink FHA from its current role of financing one-third of all mortgages, and one-half of all purchase mortgages.

MBA supports FHA's role as a source of financing for first-time homebuyers and other underserved groups. However, because of the wide disparity between FHA's downpayment requirement of 3.5 percent and the QRM requirement of 20 percent, MBA believes the proposed risk retention rule would force over-utilization of FHA and other Government programs. While FHA should continue to play a critical role in our housing finance system, MBA firmly believes that it is not in the public interest for a Government insurance program like FHA to dominate the market, especially if private capital is ready and willing to provide reasonable financing for the same borrowers.

Conclusion

MBA believes the recent changes announced by FHA are fiscally prudent and warranted given the financial realities described in the Actuarial Review of FHA's MMI Fund for Fiscal Year 2012. MBA also understands that over this next year, examining the potential and need for any further legislative FHA reforms will be a top priority for the Congress, HUD, and other policy makers as you consider various balanced options intended to help FHA maintain its mission focus and remain fiscally sound over the long term.

As that discussion intensifies, MBA stands ready to work with this Committee as a resource to ensure that the trade-offs associated with these options are fully recognized, appreciated, and seriously considered during any subsequent legislative debate.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM GARY THOMAS

Q.1. How would a reduction in FHA market share affect high-cost regions like New Jersey and areas with a higher density of condominium markets?

A.1. Any reduction in FHA market share must be as a result of a return of the private capital to the Nation's mortgage market. In order to best serve the interests of the national and regional housing markets and economies, private capital must be available to all parts of the country and all components of the housing stock, including high-cost communities and condominium markets before FHA market share is significantly reduced.

We do have concerns that lowering the loan limits without the private market available would have a significant negative impact on many markets nationwide. The current limits are set to expire on December 31, 2013, and move to the permanent limits of 115 percent of median home price and $625,500. We have seen some return of that market in the GSE space, and hope that as the year progresses, more liquidity becomes available.

We also continue to have concerns with the restrictions placed on condominium purchases by FHA. We would argue that some of these policies actually work to the detriment of their stated goal of strengthening the viability of the FHA's pool of insured condominium loans. At a recent hearing before the House Financial Services Committee FHA Commissioner Carol Galante said that there was not any data to show that condominiums were any more risky than single-family homes. FHA's data actually shows condos performing better than single-family homes. Yet it remains difficult to purchase a condominium with FHA due to a number of restrictions. We continue to work with HUD to change these policies.

Q.2. Your organization is focused on expanding home ownership. How do we help the estimated 45 million households in the U.S. that are trapped in-between renting and owning, while making sure that we don't create another housing bubble?

A.2. Our organization is focused on ensuring that all creditworthy borrowers have access to the capital they need to enter home ownership, and the tools they require to sustain it. Not all of the renter households in our Nation will either want to own a home or have the ability to do so. However, the dream of home ownership does persist for a significant number of households in this pool, and it is up to all of us [Congress and the Housing Industry] to ensure that we provide them with the education, access to affordable capital, and a finance system that is built to promote their success in this endeavor. It is to that end that NAR supports home counseling efforts via our state and local associations and since May 2005 have promoted principles for "Responsible Lending".

Directly after the collapse of the housing finance market, NAR embarked on a journey to determine how to best design a system for housing finance going forward. Our Principles for "Reforming the Secondary Mortgage Market" were first introduced to the housing industry and Congress in late 2009. We have since updated them to include principles for promoting the return of private capital, and we currently use our updated position to advocate for com-

prehensive, effective, and efficient GSE Reform, now (*see,* link below). REALTORS® believe that an effective and efficient housing finance system whose focus is on affordable, sustainable mortgage products that are in the consumers best interest, will be in the industry's and the Nation's best interest. Only when we return to a housing finance system that functions appropriately, with the correct balance of underwriting flexibility and regulatory oversight—as it did for nearly 70 years prior to the housing boom and bust—will we be able to ensure that any further housing bubbles will not have as devastating an effect as the housing bubble that occurred during the Great Recession.

Q.3. How helpful are distressed note-sales in limiting FHA's future liabilities?

A.3. HUD's FHA distressed note sale may be helpful to the fund since FHA has to manage a growing number of distressed loans that are likely to go to foreclosure. FHA does not have sufficient resources to manage their current portfolio of foreclosed homes, and this program will help them quickly move through their troubled book of loans.

Certain characteristics and requirement make this program unique in comparison to other program NAR has previously been against:

HUD's program:

- Sells pools of defaulted mortgages headed for foreclosures.
- To qualify for the programs the loan must be:
  - At least 6-months delinquent
  - The servicer has exhausted all steps in the FHA loss mitigation process
  - The servicer has initiated foreclosure proceedings, and
  - The borrower is not in bankruptcy.
- Additionally the buyer of the notes must try to modify the mortgage and is unable to foreclose for 6 months.

Q.4. In Fiscal Year 2011, over half of all African Americans who purchased a home and 49 percent of Hispanics did so with FHA financing. Moreover, 78 percent of FHA's borrowers were first time homebuyers; the very engine of housing growth over the last few decades. These statistics are very telling. Can you elaborate on the role FHA plays for these groups, and how that relates to the mission of FHA? How might the economy be impacted by reductions in home ownership for these demographic groups?

A.4. FHA's role for first-time buyers and minority buyers has been tremendous. Since 2009, FHA has insured mortgages for more than 2.8 million first-time buyers. Were it not for FHA, these buyers would not be homeowners, and 2.8 million homes would still be on the market. This would have been devastating on our Nation's economy.

The role for minority groups is also significant. As you stated, nearly half of African Americans and Latinos who purchased a home in 2011 used FHA financing. This role was just as critical before the crisis. Even in 2001, more than twice as many minority first-time buyers used FHA than a loan that was guaranteed by

Freddie Mac or Fannie Mae. Without these buyers our economy, real estate markets, and most importantly, our communities would suffer.

Q.5. How would the change to a Fair Value Accounting system impact the ability of HUD to continue a mortgage insurance program?

A.5. We are not accountants and cannot speak to the mechanics of different accounting models. However, we do not believe that treating FHA more like a private company is in our Nation's best interest. Were FHA a private mortgage insurance company, it likely would have pulled out of market during the downturn as virtually all other PMI companies did. Had that happened, the housing market would likely still not have recovered. FHA counter-cyclical role is crucial to helping our Nation's economy during times of duress.

A fair value accounting method is an inappropriate way to analyze a public program like FHA unless the intent is to sell its assets at the time of analysis. Market conditions change and, therefore, a fair value accounting analysis is only as good as the day it is performed and only if the assets were to be sold at fire-sale prices. The FHA program should not be singled out for a less comparable and highly volatile measurement such as fair value accounting.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM GARY THOMAS

Q.1. While the Federal Housing Administration (FHA) has already taken several actions to address issues identified in the 2012 Actuarial Review, it has asked for additional authority and others have suggested additional reforms. Do you believe the following reforms should be implemented and what impact will they have on the housing market?

Increasing the minimum downpayment requirement from 3.5 percent to 5 percent.

A.1. The National Association of REALTORS® does not support an increase to the downpayment. Increasing the downpayment will do nothing to increase FHA's reserves and will disenfranchise thousands of otherwise qualified borrowers who with careful underwriting could successfully handle their mortgage obligations as well as home ownership in general.

The correlation between downpayment and loan performance is significantly less important than the linkage to strong underwriting, which FHA continues to have. Borrowers with the median income would need approximately 6.5 years to save for a 5 percent downpayment, assuming that the family directs every penny of savings toward a downpayment, and nothing for their children's education, retirement, or a "rainy day." Families saving for these other necessities will have to wait much longer. For example, a median income family that sets aside $1000 per year of its savings for college tuition or retirement would need nearly 9 years to save for even a 3.5 percent downpayment. FHA's most recent estimate was that more than 300,000 borrowers a year would not be able to make a downpayment of 5 percent and still have sufficient reserves and resources to obtain the loan.

Q.2. Requiring automatic premium increases when the insurance fund falls below a statutory minimum.

A.2. FHA has increased premiums 5 times since 2009. We have not opposed these premium increases that were necessary to protect the FHA fund. However, we believe FHA is the most appropriate arbiter of when to increase premiums. We support legislation to provide FHA with flexibility to change program requirements when necessary to protect the Fund. These include greater flexibility on setting premiums, changing loan policies, and other program changes. We believe FHA should have to go through some public notice process for significant changes, but don't believe the Agency should have to go to Congress for every program change.

Q.3. Strengthening the FHA's indemnification authority for all lenders.

A.3. We support legislation that provides FHA with authority to seek indemnification from direct endorsement (DE) lenders. Indemnification protects FHA from insurance claims where the lender is guilty of fraud, misrepresentation or noncompliance with applicable loan origination requirements. FHA currently has authority to require indemnification from lenders with Lender Insurance approval only. DE lenders represent 70 percent of all approved lenders, and Congress should require that FHA receive indemnification from them. This will provide significant level of protection for taxpayers when fraud has been committed.

Q.4. Giving the FHA authority to transfer servicing.

A.4. NAR does not have policy on this issue.

Q.5. Strengthening the 2 percent capital level.

A.5. FHA's 2 percent capital reserve requirement is simply a number arbitrarily assigned to demonstrate FHA's financial soundness. We support measures to ensure FHA's financial stability and ongoing availability. We do not have any specific recommendations related to the level of the capital reserves.

Q.6. The Federal Housing Administration (FHA) has raised premiums five times since 2009. What impact has that had on the market? Has it encouraged the return of private investment?

A.6. We have seen a significant increase in private investment in mortgage markets. Private level of involvement remains low but is growing. This could be as a result of a number of factors—including growing investor confidence, stabilized housing prices, or increased pricing by FHA. NAR welcomes the return of the private market and a return of FHA to its traditional market share of 10–15 percent of the mortgage market. But we are not there yet. The private market is wary of regulations like QM, QRM, and Dodd-Frank oversight, and uncertain about the future of the secondary mortgage market. Regardless of what you do to FHA, a robust private market simply isn't willing to return yet. We oppose increasing FHA premiums simply to try and force the private market back to return. Doing so will simply price buyers out of FHA and reduce the size of the market overall.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM PETER H. BELL

Q.1. HUD has recently discussed consolidating the HECM Fixed Rate Standard and Saver programs. Can you discuss how this change might generate savings? What other effects might it have?

A.1. As of April 1, 2013, HUD has "consolidated" the HECM Fixed Rate Standard and Saver programs. What this means, essentially, is that a fixed-rate HECM at the higher principal limits available from the "Standard" is no longer available. Any prospective borrower interested in obtaining a HECM with a fixed interest rate would have to choose the "Saver" option with the lower amount of money available.

The issue with fixed-rate Standard has been that the interest accrual on the larger initial draws grows relatively quickly, potentially causing the loan balance to exceed the value of the home. The Saver addresses this by advancing a smaller percentage of the home's value, leaving a larger "cushion" of value to cover the interest accrual over time. This will help the program avoid some payouts for claims.

A primary effect is that borrowers will now choose between a variable rate Standard, in which they can draw down less than the full principal limit up front and utilize the remaining amount over a longer period of time, or Saver loans which have a more conservative principal limit (Loan-to-Value). These options all present lower risk to the FHA.

Q.2. Over the next decade, the population of seniors 62 and over will continue to grow. How important is the HECM program considering this growth and the unfortunate reductions in many of these same households' retirement wealth?

A.2. There are (depending on the data source) between 60 million and 70 million "Boomers" approaching retirement. Half of them have little or no savings. Among the half who have savings the average is under $125,000. At the same time, many in this cohort have accumulated substantial wealth in their homes. That housing wealth will be an important resource for funding longevity. A significant proportion of these Boomers will live well into their 80s, and many into their 90s.

The HECM program is an important tool for giving older Americans access to that substantial housing wealth. It plays an equally important role as an "incubator" providing valuable data and experience to be used by the private sector and investment community to develop complimentary products that could enter the marketplace alongside the FHA option.

Q.3. You remark in your written testimony on the evolution of the HECM program over the last few decades and the changing demographics of its beneficiaries. Could you elaborate on this? What problems is HUD facing with respect to HECM loans, attributable to these changes?

A.3. When the HECM program was first authorized, the general thinking behind it was that it would serve older married couples who had lived in their homes for many years and would have little or no debt left on their property. Therefore, the HECM would pro-

vide some supplementary "income" on a monthly basis to help improve their cash flow and assist in paying bills.

Changes in housing markets generally, higher costs for homes in many areas, larger mortgages balances, and the opportunity to refinance as interest rates came down, led to many older homeowners having significant mortgage balances on their property well into their later years. Once the financial meltdown wiped out savings, diminished the value of other investments, and led to job loss and retirement earlier than anticipated, some homeowners found that they could no longer make the payments on their existing mortgages.

The HECM program provided a solution by enabling homeowners to pay-off their existing mortgages with HECM loans, eliminating the monthly payment so that the cash that had been used to make mortgage payments would be available to cover other living expenses.

The problem with this approach, as we have learned, is that in some cases, HECM borrowers have still been unable to manage their cash flow and meet their obligations, leading them to become delinquent in paying taxes and insurance premiums on their properties. That has led to an uptick in technical defaults for non-payment of property charges by HECM borrowers who had exhausted their reverse mortgage funds and could no longer meet their obligations.

Q.4. It has been brought to Congress' attention that assessing a HECM applicant's finances may help lenders provide better product options, though it may keep some households from receiving access to this popular program. How can HUD and lenders develop an assessment framework that balances HUD's fiscal solvency with fair access for borrowers?

A.4. Once of the solutions to the problem discussed in my preceding answer is to implement a "financial assessment" of prospective borrowers as part of the HECM application process. Financial assessment would be a form of limited underwriting, but differs from underwriting for forward mortgages, that would look at sources of funding available to the homeowner, including income from Social Security and pensions, retirement savings and assets that can be spent down, and proceeds from the HECM loan. The objective of this assessment would be to ascertain that the prospective borrower(s) has the ability to meet their obligations to pay taxes and insurance, and still has enough residual income available to pay other living expenses.

One concern has been that some prospective borrowers might be shut out of the program. However, it is our opinion that this type of underwriting, for the most part, will disqualify prospective borrowers who have a likelihood of failure with the HECM loan, but not those with the wherewithal to succeed.

Q.5. How fast and flexible would HUD's response to the HECM issue be if it had to rely on the current regulatory rule-making process? How can we make sure that HUD considers stakeholder remarks before issuing "mortgagee letters" to make policy?

A.5. Under the current rulemaking process, it would take HUD 18–24 months to implement the changes that all stakeholders appear

to agree would be appropriate. Furthermore, if any fine-tuning were required as lessons are learned thru implementation, the regulatory development process would have to be done again. Alternatively, if given the authority to make changes via Mortgagee Letter, HUD could implement changes in 60–90 days.

HUD has always been very open to input from the various stakeholders interested in the HECM program including senior advocacy groups, the counseling community and the industry. We all meet and converse frequently and HUD actions are generally taken only after deriving consensus among the parties involved. If members of Congress are concerned about making sure that HUD considers stakeholder concerns, report language can be drafted instructing HUD to do so while implementing any program changes.

NRMLA believes that HUD has been a responsible steward of the HECM program and has been open and thoughtful in obtaining input and feedback. We are comfortable that this would continue to be the case.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM PHILLIP L. SWAGEL

Q.1. You propose in your testimony that FHA insurance should not be offered to borrowers with a foreclosure in the last several years. That seems a little broad considering that many FHA borrowers with performing loans are defaulting, not because of inherently bad credit decisions, but because of our economy. How would you discern between these types of borrowers and those that are considered "bad" credit risks?

A.1. Private market participants see recent foreclosure as a risk factor for future default. Industry reports indicate, for example, that a foreclosure has a considerable negative impact on a borrower's credit score for 7 years, with the impact diminishing over time. This suggests that it is appropriate for the FHA likewise to consider past loan performance, including an outright prohibition on offering FHA insurance to borrowers for 5 to 7 years as suggested in my written testimony. Income shocks such as unemployment are a key contributing factor to foreclosure, particularly in combination with a negative equity situation. To be sure, there will be some potential borrowers who will have a past default arising from a job loss but then find a secure job and have the capacity to make mortgage payments in the future. It would be difficult, however, to distinguish such potential borrowers from others whose job situations are not as secure—this discernment is simply difficult. Avoiding inappropriate risks for taxpayers thus means unfortunately that some potential borrowers will have to wait to become eligible for a mortgage. It should be noted as well that this situation provides a motivation for moving forward with overall housing finance reform that would encourage the return of private capital to fund mortgages, including for the return of private capital providers willing to take on the risks involved with lending to borrowers who do not qualify for Government-backed programs.

Q.2. Of loans originated and insured by FHA in 2010 and after, it is reported that 70 percent of performing loans had a downpayment of less than 5 percent and approximately two-thirds of borrowers

had a FICO score of less than 680. Doesn't this demonstrate that FHA is a source of strong, performing loans?

A.2. Yes, the FHA supports many performing loans. Unfortunately, the FHA also backs many loans that are not performing. Indeed, as Joseph Gyourko points out, the delinquency rate for FHA-backed loans originated in 2010 and after is considerably higher than that for other loans, most of which comply with GSE lending standards and thus involve larger downpayments and more stringent underwriting standards than FHA-supported loans (*see,* Gyourko's April 2013 paper entitled "Unfounded Optimism: The Danger of FHA's Mispriced Unemployment Risk" available on the AEI Web site). This is illustrated in the Table below, which is taken from Gyourko's paper. FHA vintages, from 2010 on, had a serious delinquency rate of 12 percent in the third quarter of 2012, compared to only a 4 percent serious delinquency rate for all mortgages included in the Mortgage Bankers Association survey (which includes FHA loans, meaning that the non-FHA loans had an even smaller delinquency rate than 4 percent).

TABLE 2

SHARE OF SERIOUSLY DELINQUENT LOANS IN THIRD QUARTER 2011 AND THIRD QUARTER 2012

(BY ORIGINATION YEAR)

	FHA			
	2010+	2008–09	2005–07	<2005
2011(3)	5%	46%	25%	25%
2012(3)	12%	45%	20%	23%
	All Loans			
	2010+	2008–09	2005–07	<2005
2011(3)	1%	14%	63%	22%
2012(3)	4%	16%	55%	22%

Sources: Mortgage Bankers Association, "National Delinquency Survey, Q3 2011, Briefing Materials;" and Mortgage Bankers Association, "National Delinquency Survey, Q3 2012, Briefing Materials."

Q.3. Do you agree with the findings of Moody's Analytics that the loss of FHA as an institution in 2010 would have meant the loss of 3 million jobs, mortgage interest rates increasing by 6.7 percent, and a 2 percent decrease in the GDP? If not, please detail why.

A.3. No. While I have considerable respect for the work of Moody's Analytics, I believe that these findings are overstated. For mortgage interest rates, for example, the policy actions of the Federal Reserve have held mortgage interest rates at low levels and would have continued to do so regardless of the participation of the FHA. Similarly, without FHA lending, potential FHA borrowers would have continued to consume housing services. Some households would have taken out non-FHA loans (including some who would

have waited longer to accumulate a downpayment before purchasing a home), while others would have rented. The spending on housing would not have disappeared from the economy—it would have taken place in a different way. This is not a judgment about whether the hypothetical absence of the FHA would be good or bad for the individual families, but only that the impact on the overall macro economy is overstated. The FHA provides a subsidy to some borrowers at a cost to the Federal Government and thus to overall taxpayers. This is best seen as a transfer of resources.

Q.4. Are downpayments by themselves a robust indicator of loan riskiness? What are your thoughts on this? How else might loans be deemed "safe" or "risky"?

A.4. As discussed by Gyourko, economic research suggests that the combination of negative equity and income loss together are key indicators of default. Gyourko refers to this as the "double trigger" hypothesis. He goes on to explain that a homeowner with negative equity is at risk of default, but the vast majority of underwater borrowers remain current. An income loss such as unemployment is then the second factor that triggers a default. The small downpayment requirements at FHA are thus an element that makes these loans risky compared to loans with larger downpayments, since homeowners with little equity in their homes are more likely to become underwater than those with considerable equity. This line of thought suggests that the riskiness of a mortgage encompasses multiple factors, including the potential homebuyers' income and credit history, the type of mortgage product, and the overall and local economic environments.

Q.5. How would the change to a Fair Value Accounting system impact the ability of HUD to continue a mortgage insurance program?

A.5. Use of fair value accounting would mean that the risks of Government financial activities such as FHA-backed mortgages are more accurately gauged as compared to use of the accounting convention of the Federal Credit Reform Act (FCRA). As noted in my written testimony, the current FCRA accounting treatment allows the FHA to book a profit when it guarantees loans to riskier borrowers and on less stringent terms than loans that private sector lenders would be willing to make. This is an unwelcome artifact of the accounting treatment. Use of fair value accounting provides a more accurate assessment of the costs involved with FHA activities. The better accounting treatment does not change the benefits of FHA activities. So long as Congress is willing to devote the funds needed, use of a more accurate accounting treatment would not affect the ability of HUD to continue a mortgage insurance program.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM PHILLIP L. SWAGEL

Q.1. While the Federal Housing Administration (FHA) has already taken several actions to address issues identified in the 2012 Actuarial Review, it has asked for additional authority and others have suggested additional reforms. Do you believe the following reforms

should be implemented and what impact will they have on the housing market?

- Increasing the minimum downpayment requirement from 3.5 percent to 5 percent.
- Requiring automatic premium increases when the insurance fund falls below a statutory minimum.
- Strengthening the FHA's indemnification authority for all lenders.
- Giving the FHA authority to transfer servicing.
- Strengthening the 2 percent capital level.

A.1. Yes, I believe that all of the reforms should be undertaken. These reforms would increase the protection for taxpayers ahead of the risks involved with FHA backing for mortgage loans, while providing the FHA with a greater ability to go after lenders and services that do not follow agency guidelines.

These steps would have an impact on the housing market, generally with a modest negative impact but not entirely. Higher downpayment requirements would mean that some potential borrowers would have to wait longer to accumulate a 5 percent downpayment than the 3.5 percent downpayment. At the same time, this would increase the protection for both taxpayers and homeowners against default and foreclosure, since there is considerable evidence that underwater borrowers are at elevated risk of foreclosure (especially in the wake of income shocks). Requiring higher insurance premiums and more capital at the FHA would protect taxpayers against the need to bail out the FHA insurance fund (which might be needed this year), but lead to higher mortgage interest rates for borrowers—these higher rates would reflect the increased protection for taxpayers.

The housing market is in recovery and could absorb the moderate impacts of these steps to better protect taxpayers against the risks involved with FHA-backed mortgages.

Q.2. The Federal Housing Administration (FHA) has raised premiums five times since 2009. What impact has that had on the market? Has it encouraged the return of private investment?

A.2. Higher insurance premiums for FHA loans correspond to greater protection for taxpayers but translate into increased mortgage interest rates for homebuyers. As noted in my written testimony, analysis by the CBO indicates that FHA premiums are still set at rates below those that would correspond to "fair value" protection for taxpayers—FHA premiums involve a 1.5 percent cost (a positive subsidy rate) using fair value accounting (even though the FHA books a profit on its guarantees because it does not fully account for the risks involved with its activities). The CBO analysis thus indicates that FHA premiums are still underpriced and taxpayers under protected even with the premium increases of the past several years.

Increased FHA insurance premiums are one factor that would tend to foster the return of private capital to housing finance but are just one part. Considerable uncertainty over the legal and regulatory treatment of fully private mortgages stands in the way of a return of nonguaranteed securitized lending. There has been a

modest increase in private funding of mortgages over the past several years, but the vast majority of loans are still backed by the Federal Government through the FHA, the two GSEs, and other Government agencies such as the VA and USDA. At the same time, the GSEs along with the FHA have essentially no MBS-level private capital in front of taxpayers (and the FHA has relatively little mortgage-level private capital since it allows modest downpayments). It would be useful to institute reforms along several dimensions: to continue to rationalize the pricing of FHA insurance premiums; to reduce the maximum dollar amount of FHA-backed mortgages; and to bring in private capital in a first-loss position ahead of Government-backed loans.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM SARAH ROSEN WARTELL

Q.1. Are downpayments by themselves a robust indicator of loan riskiness? What are your thoughts on this? What else might regulators, lenders, and servicers look at?

A.1. No one factor makes a loan risky. It is the layering of risk that should be controlled rather than single-minded focus in all cases on downpayment or equity. Of course, downpayments are an important component in determining the default and loss risk in a mortgage. Homeowners are less likely to default if they have equity in their house and, if there is equity, the size of potential loss may be smaller. Also, the ability to save for a downpayment is evidence relevant to future payment performance. However, downpayment is only one determinant of risk and it is very important that loans are assessed comprehensively.

One of the unfortunate consequences of practice and regulatory changes in the aftermath of the crisis has been the hardening of underwriting, so that each factor is increasingly applied as a screen rather than part of a balance of factors that together represent the level of risk. Good underwriting involves consideration of compensating factors that might offset elevated risk that might be reflected by another factor. Good credit history, stable income, loan terms (such as a quicker amortization schedules as with 15-year mortgages) are proven factors. And we need to better measure and prove the impact of other compensating factors such as participation in high quality credit counseling or matched savings programs. Finally, we do not fully understand why certain origination channels do a better job of underwriting loans that will perform well, even when the borrowers' credit profiles seem similar on paper.

Q.2. What role does housing counseling play in FHA insurance? Should it be more integrated in the normal underwriting process?

A.2. I am confident that housing counseling—both prepurchase counseling and default prevention counseling—can reduce risk. But not all counseling is equally effective. For example, it is not well understood whether mandatory counseling is as effective as voluntary counseling. The borrower's motivations, the timing of the counseling, the quality of the counseling, and many other factors vary—and so the impact of counseling on risk is hard to predict in every case. We need more precise and rigorous research so that we

can give lenders and bearers of credit risk greater confidence that they can rely upon the availability of high quality counseling in assessing mortgage risk.

One of FHA's reasons for being is to help support positive innovation. Well scaled pilot programs that test and evaluate rigorously the impact of credit counseling on different kinds on loan performance would be a valuable way for FHA to contribute to strengthening outcomes for lenders and borrowers across the housing system. Learning developed in the FHA context could spread across the larger system.

There are difficult issues to address, however. The first is finding a financing mechanism to incorporate housing counseling into FHA insurance. With proven risk reduction, it might make sense for lenders or insurers to help finance counseling. But sometimes the best outcome from counseling is a decision to delay a purchase. And the economic incentives may not be aligned well in a lender-pay model. An alternative is to create an economic or access incentive for the borrower to undergo high quality credit education. But if we want to design that incentive, we should try to make it commensurate with the reduction in risk. Thus, piloting with rigorous evaluation and measurement of different funding models is the key to bringing housing counseling to scale for FHA and the broader system of housing finance.

Q.3. Is it a fair expectation that FHA should at times operate less fiscally efficiently to promote credit access for low and moderate income borrowers?

A.3. Yes, but not only for the benefit of low and moderate income borrowers, but also for the benefit of all of us who live and work in the U.S. economy.

FHA was designed to operate at no net cost to the taxpayer over time. However, because FHA does not have private shareholders and quarterly reports to investors, it can be the patient market participant who can insure across the credit cycle. Some books of business will perform well, and FHA can build up a capital reserve that will help to offset unexpected losses when markets are weak. To the extent losses occur on some of this business, FHA has the ability to diversify across time and even make up for these losses in subsequent years if prior reserves prove inadequate. The FDIC works in a similar way.

This countercyclical role is especially important for moderate income homebuyers. It is important for home-sellers too, ensuring that credit is available for purchasers so families can sell when they need to move or recover equity. In times of tight credit, working families and minority community especially bear the brunt of limited credit. But all of us benefit when FHA is willing to continue to insure into a down market, with understanding that those books of business will perform less well and could even incur losses that would need to be recovered later. This role breaks downward spirals and prevents larger losses to all credit providers and the macro economy.

Q.4. Many critics of FHA state that loans insured by the agency are just like subprime loans. How would you respond to that?

A.4. While FHA defaults are too high right now, its default rates are still well below the default rates of subprime mortgages originated in the last decade principally funded by private-label securitization. Subprime serious delinquency rates peaked at approximately 30 percent while FHA mortgages peaked at slightly below 10 percent. FHA loans are, on average, higher risk than prime, but lower risk than subprime.

Though FHA loans may often share some risk attributes with subprime loans, these attributes alone do not make FHA insured loans subprime. FHA mortgages tend to be fully underwritten and usually have some compensating factors that limit risk. Subprime loans originated last decade often had shoddy underwriting and layered risks.

Q.5. FHA Commissioner Galante testified before the House recently that there were still outstanding requests for additional authority HUD needs to improve the insurance program, like indemnification against Direct Endorsement lenders and the ability to terminate origination and underwriting approval. Can you enlighten us about how these would help?

A.5. I believe that there are a wide range of additional authorities, some requested by HUD and some that I propose in my testimony, that could strengthen the capacity of FHA to reduce taxpayer exposure to risk.

Looking at FHA's recent performance, a key pattern emerges. FHA could have avoided some of its losses if it had not been for structural barriers to faster change at the agency—barriers that prevent the type of prompt response a private company is able to make to protect itself against risk. FHA needs new tools and increased flexibility to act quickly to manage and mitigate risk to protect both taxpayers and borrowers.

FHA also needs to have the flexibility to spend insurance proceeds for analytic services and better systems to understand what risk it is taking and be able to act to reduce excessive risk, with a particular focus on how to manage the layering of risk on low-downpayment mortgages.

On the specific authorities that you mention, FHA officials have been asking Congress for since 2010 is the ability to require indemnification from direct endorsement lenders. FHA also would benefit from the ability to more quickly terminate a lender's ability to originate FHA-insured loans. Under current law, FHA can only hold these lenders accountable for fraudulent activity if they "knew or should have known" of its occurrence. FHA needs to be allowed to impose higher, but also clearer, standards so lenders are accountable for fraud in FHA-insured loans. This is an example of an area where I believe current legislation is too prescriptive, requiring FHA to wait for legislative action before they can make program changes to lower taxpayer risk. The goal should be to give the taxpayers—not program participants—the benefit of the doubt.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM SARAH ROSEN WARTELL

Q.1. While the Federal Housing Administration (FHA) has already taken several actions to address issues identified in the 2012 Actu-

arial Review, it has asked for additional authority and others have suggested additional reforms. Do you believe the following reforms should be implemented and what impact will they have on the housing market?

Increasing the minimum downpayment requirement from 3.5 percent to 5 percent.

A.1. No. Increasing the minimum downpayment will make financing less accessible to many responsible potential borrowers, and likely dampen the housing market recovery and reduce low-income and minority family home ownership rates. While downpayments are an important component in determining the default risk in a mortgage, no one factor makes a loan risky and it is the layering of risk that must be controlled.

As I noted in a response to questions from Senator Menendez, one of the unfortunate consequences of practice and regulatory changes in the aftermath of the crisis has been the hardening of underwriting, so that each factor is increasingly applied as a screen rather than part of a balance of factors that together represent the level of risk. Good underwriting involves consideration of compensating factors that might offset elevated risk that might be reflected by another factor. Good credit history, stable income, loan terms (such as a quicker amortization schedules as with 15-year mortgages) are proven factors. And we need to better measure and prove the impact of other compensating factors such as participation in high quality credit counseling or matched savings programs. Allowing some of these factors to offset the risk of lower downpayments is an appropriate way to make credit available while still protecting taxpayers.

Q.2. Requiring automatic premium increases when the insurance fund falls below a statutory minimum.

A.2. No. Requiring automatic premium increases when the insurance fund falls below a minimum could conflict with the countercyclical role of FHA.

As I noted in response to another question, FHA was designed to operate at no net cost to the taxpayer over time. However, because FHA does not have private shareholders and quarterly reports to investors, it can be the patient market participant who can insure across the credit cycle. Some books of business will perform well, and FHA can build up a capital reserve that will help to offset unexpected losses when markets are weak. To the extent losses occur on some of this business, FHA has the ability to diversify across time and even make up for these losses in subsequent years if prior reserves prove inadequate. The FDIC works in a similar way.

Automatic premium increases would take away the discretion of policy makers to assess credit availability, evaluate the capacity of the fund to recoup its capital cushion over time, and make a decision when premium increases are appropriate. As we saw over the most recent crisis, FHA policy makers increased FHA premiums in multiple steps. An abrupt process could have a destructive impact on credit markets at a time when they are most fragile.

Q.3. Strengthening the FHA's indemnification authority for all lenders.

A.3. Yes. Currently, FHA can only seek such indemnification from lender insurance (LI) lenders. Since 2010, HUD has sought to ensure that both direct endorsement (DE) and LI lenders are liable to indemnify the secretary for losses on loans they originate that do not comply with FHA guidelines. This change will provide for equal treatment of both classes of lenders and empower the agency to reduce losses. Sound underwriting is always important and if anything eliminating abuses will help the economy in the long run.

Q.4. Giving the FHA authority to transfer servicing.

A.4. Yes. The failure of lenders to take appropriate loss mitigation steps can result in higher than necessary claims to the FHA Fund and homeowners losing their homes unnecessarily. This authority will not only deal with ineffective servicers but create a powerful incentive for better servicing. Reducing defaults will have a beneficial effect on neighborhoods and the economy.

Q.5. Strengthening the 2 percent capital level.

A.5. A modestly higher level of reserves would help ensure that measures are taken sooner to stabilize the fund. And also would help prevent pressures, during good times, to reduce premiums unnecessarily. By its nature, insurance involves building cushions for a rainy day. The key is balancing the goal of protection against creating unnecessary homebuyer costs and barriers to home ownership. Recognizing that capital can be replenished after a crisis helps to find that proper balance.

Q.6. The Federal Housing Administration (FHA) has raised premiums five times since 2009. What impact has that had on the market? Has it encouraged the return of private investment?

A.6. Both FHA and the GSEs have significantly raised their fees. The GSE fee increases have limited the impact of FHA premium increases in shifting the market back to conventional loans with private mortgage insurance. However, an FHA mortgage is now more expensive than a conventional mortgage with private mortgage insurance for many borrowers. As a result FHA share has now fallen to approximately 25 percent of the purchase money originations from a peak of around 35 percent. In effect, the market is segmented between the very safe high-LTV loans that the GSEs and mortgage insurers capture and the modestly riskier loans that FHA insures.

The credit standards of GSE eligible loans and FHA loans are another important factor influencing the market share. The pricing differentials should mean that loans will go to the GSE/private mortgage insurance channel when possible.

Funding of loans by private MBS securities has not returned at scale yet, but the barriers there have less to do with FHA pricing and more to do with the need to clarify servicing standards, duties to investors, regulatory treatment of private MBS loans, and other issues that are gradually being resolved by voluntary industry and regulatory action.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM TERESA BRYCE BAZEMORE

Q.1. Is the current FHA 100 percent loan guarantee sustainable? Is it a significant roadblock to the private mortgage insurance industry? Are there changes in the targeting of the insurance—perhaps only on a percentage of the loan value rather than the entire unpaid principle balance—that might reduce losses to the MMIF while keeping mortgage credit available to low and moderate income households? Would this credit enhancement be sufficient to stimulate lenders to use FHA insurance?

A.1. A 100 percent FHA guarantee exposes the MMIF to significant losses in the event of a significant decline in home prices, as we have seen over the past few years. Without capping the potential losses that FHA can sustain, the premiums would need to be reevaluated and likely increased to make sure that the fund has adequate reserves to pay claims during stress periods.

Furthermore, since FHA insures 100 percent of the loan amount, loan originators lack any meaningful risk of loss. Currently, taxpayers are on the hook for the over $1 trillion in mortgages that FHA is insuring. This 100 percent guarantee does not properly align incentives between originators and the FHA and is particularly untenable given FHA's potential financial exposure to taxpayers.

Private mortgage insurance (MI), on the other hand, places private capital in a first loss position behind the borrower's equity and generally represents 25 percent to 35 percent of the loan amount, which covers most, but not all, of the losses that the parties to the mortgage transaction experience. As a result, when private MI is used, there remains an incentive to avoid foreclosure. Notably, the Federal VA mortgage program provides limited coverage of 25 percent to 50 percent for the loans insured under its program. Thus, there is no reason to believe that a reduced guarantee would create a disincentive for lenders to use the FHA program.

Congress should reduce the FHA's guarantee below its current 100 percent level—similar to the VA mortgage program. Reducing the 100 percent coverage amount will provide lenders with an incentive to conduct prudent underwriting. Reducing the 100 percent coverage amount will also reduce taxpayer exposure to losses resulting from borrower default, and this will reduce the budgetary cost of FHA's program. The success of the VA program demonstrates that this lower level of coverage results in better underwriting and loan performance, which reduces both the probability of default and severity of loss.

Q.2. Discuss the lender originations process of FHA's mortgage insurance compared to its counterparts at the VA and the private mortgage insurance industry?

A.2. The lender origination process differs materially between FHA and privately insured conventional loans. With respect to FHA loans, most lenders use "delegated authority." The FHA guidelines are traditionally more liberal than acceptable guidelines for conventional loans on a number of different criteria, including credit score, credit history, job history, and debt-to-income, among others. There is also minimal front end quality control review by FHA and/

or an upstream correspondent aggregator. Once a lender using delegated authority processes and closes a loan (presumably within the guidelines of FHA), FHA will insure the loan, providing 100 percent insurance. Originators know that once an FHA loan is closed, it rarely gets reviewed for quality control, and in the rare case that a defect, fraud, or misrepresentation is found, the originator can simply "indemnify" against FHA loss instead of buying the loan back and "owning" the asset and the risk.

With respect to privately insured conventional loans, on the other hand, the review process for approving originating companies is significantly more rigorous, and the contract stipulations and representations and warrants are more stringent. The underwriting (whether delegated or not) and the guidelines are more likely to produce a sustainable mortgage. The private MI company typically provides coverage in an amount that generally represents 25 percent to 35 percent of the loan amount, which results in diligent origination and review. Also, quality control sampling is undertaken and loan performance is closely monitored to mitigate the risk of underwriting error and to determine when any changes to guidelines are warranted, including opportunities to expand guidelines. Also, privately insured conventional mortgages are subject to more quality control because, in the case of a defect, fraud, or misrepresentation, the GSEs may require a lender to repurchase the loan (with interest). The repurchase requirement on conventional loans is far more cumbersome and costly to lenders than FHA's indemnification process.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM DAVID H. STEVENS

Q.1. QM is mostly about consumer protection on individual loans and QRM is mostly about securitization of mortgage-backed securities and identifying loans that are less likely to default. Those two categories often overlap, but are there any loans where they don't overlap? Where might the FHA fit in this formula?

A.1. QM and QRM are really different sides of the same coin, with the end goal being borrowers receiving mortgages that they can repay. The final QM rule has eliminated the vast majority of the practices that lay at the heart of the housing crisis, and creates a standard that ensures borrowers receive loans that fit their circumstances. Implementing a narrower rule for securitizations could have a devastating impact on access to affordable credit by squeezing the credit box even tighter, and potentially endanger Congress' nascent reform efforts.

Q.2. Recent reports from Core Logic in February make statements that QM and QRM would remove 60 percent of loan originations while removing 90 percent of the risk. First, is this a fair characterization of what these rules would do? Second, isn't it true that these estimates wouldn't come to fruition for several years under CFPB's exemption of agency loans into the QM safe-harbor?

A.2. While we anticipate the impact to actually be smaller overall, imposition of a narrower QRM will cause more significant damage to the long-term competitiveness of the housing finance market due

to the increase in the Government's market share, driven by virtue of their exemptions from these rules.

Q.3. What steps is FHA taking in terms of improvements to risk management and fee increases to help mitigate the chances that they may require a draw on their permanent budget authority from the Treasury?

A.3. In response to the possibility that FHA may need a draw from the U.S. Treasury, FHA recently announced a series of program changes aimed at increasing revenue, reducing credit risk, and improving the management of the existing portfolio. MBA believes that these recent changes are fiscally prudent and warranted given the financial realities described in the Actuarial Review.

Specifically, in late January 2013, FHA announced the following administrative changes directly aimed at either increasing revenue or reducing credit risk:

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

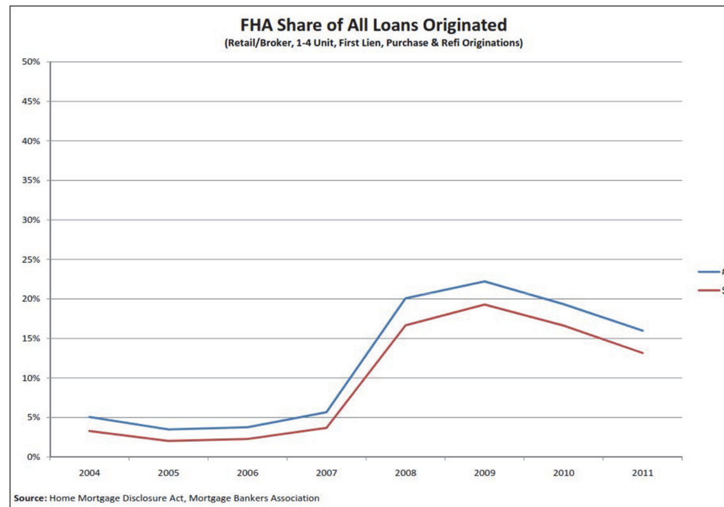
In addition, FHA proposed decreasing the loan-to-value (LTV for) loans above $625,500 from 96.5 percent to 95 percent. MBA supports this proposal.

Q.4. We all agree that FHA has a strong role in our economy as a countercyclical agent, but as the economy improves, how do we ensure that its share migrates back to the private market in a responsible manner?

A.4. During the recent financial crisis, when private capital stepped back from the marketplace, lenders shifted much of their production to FHA-insured loans. As seen in the chart below, FHA's market share spiked beginning in 2007, peaked in 2009, and has steadily declined since then. MBA is working with its members to define policy options, such as allowing the current high cost loan limits to expire at the end of this year, which will ensure that private capital continues to reenter the housing finance market in a responsible and sustainable fashion. Any decision regarding substantial, systemic changes, however cannot be done in a vacuum. Changes that shift the role of FHA within the housing finance system should be done in conjunction with consideration of the future roles of the Government sponsored enterprises (GSEs). Adjust-

ments in how the FHA, Ginnie Mae, Fannie Mae, or Freddie Mac function within the system can be expected to affect the operations, policies, and market share of the others. Prudent action is necessary in order to limit unintended consequences that could be detrimental to the entire U.S. economy.

Addressing FHA's Financial Condition and Program Challenges, Part II
February 28. 2013



Q.5. How would the change to a Fair Value Accounting system impact the ability of HUD to continue a mortgage insurance program?

A.5. A study performed by the Congressional Budget Office (Accounting for FHA's Single-Family Mortgage Insurance Program on a Fair Value Basis, May 18, 2011) notes that the costs of FHA's single-family mortgage insurance program are recorded in the Federal budget using the methodology spelled out in the Federal Credit Reform Act of 1990. Under Federal Credit Reform requirements, the FHA program would produce budgetary savings of $4.4 billion. On a fair value basis, according to the CBO, the FHA program costs $3.5 billion. The main difference between the estimates under the FCRA approach and fair value accounting relates to the effective discount rates used against the same projected cash flows. Federal Credit Reform utilizes interest rates on Treasury securities whereas fair value estimates are discounted using rates that incorporate a premium for market risk (i.e., in addition to credit risk). Under fair value accounting, estimating the FHA's MMI Fund economic value estimates would become more volatile in response to noncredit risk related events. In the current situation with FHA on the edge of solvency, more volatility could make it harder for Congress and HUD to chart a steady course to re-establishing the fund's statutory reserve ratio.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR HEITKAMP FROM DAVID H. STEVENS

Q.1. While the Federal Housing Administration (FHA) has already taken several actions to address issues identified in the 2012 Actuarial Review, it has asked for additional authority and others have suggested additional reforms. Do you believe the following reforms should be implemented and what impact will they have on the housing market?

Increasing the minimum downpayment requirement from 3.5 percent to 5 percent.

A.1. The MBA cautions that while any increase in FHA's minimum downpayment requirement would immediately improve FHA's risk profile on new business, it could come at an unacceptable social cost. An increase of the minimum downpayment from 3.5 percent to 5 percent for FHA-insured loans would reduce expected losses to the Mutual Mortgage Insurance (MMI) Fund through lower default rates and lower loss severity in the event of default. This step would increase the economic value of future books of business, but obviously would do nothing to reduce losses already on the books. Moreover, the performance of the 2010–2012 books—which have seriously delinquent rates of less than half of those for the 2008–2009 books at a comparable age—clearly indicates that higher downpayments are not a necessary condition for a strong performing book. The social consequences of increasing the minimum downpayment requirement could be dramatic and would unnecessarily delay a purchase for many Americans who might be successful homeowners.

Q.2. Requiring automatic premium increases when the insurance fund falls below a statutory minimum.

A.2. Since 2009, FHA has increased the annual mortgage insurance premium (MIP) five times. MBA is currently working with its members to examine policy options for FHA, including tying increases in the MIP to the capital ratio of the MMI Fund, which restore FHA's single-family programs to fiscal solvency; preserve FHA's traditional housing mission; and maintain FHA's countercyclical role.

Q.3. Strengthening the FHA's indemnification authority for all lenders.

A.3. In recent years, FHA has greatly increased its enforcement of agency-approved lenders. The prospect of tough administrative and legal enforcement actions provides strong incentives for lenders to carefully follow FHA program guidelines. These enforcement actions also increase revenue for the MMI Fund. MBA unquestionably supports high standards for all lenders that participate in FHA programs in order to protect the agency's viability, the lender's reputation, and the reputation of the industry. There must, however, be a reasonable allowance for human error, certainly when the error is not the cause of the delinquency or default. MBA staunchly opposes efforts that would allow FHA to go beyond reasonable standards of lender enforcement.

Q.4. Giving the FHA authority to transfer servicing.

A.4. MBA would have to consider a number of factors associated with granting FHA a right to transfer servicing rights. In particular, MBA would need to understand the reach of HUD's authority and specifically what causes of action would trigger a transfer and on what book of business; what compensation would be paid for the valuable servicing asset; the length of time permitted to effectuate the transfer; the impact of such authority on the price and value of FHA servicing assets, which may impact all servicers' balance sheets, not just those subjected to transfer; and the impact on borrowers and their relationships with servicers, given many borrowers may purposely consolidate other financial business with the servicer.

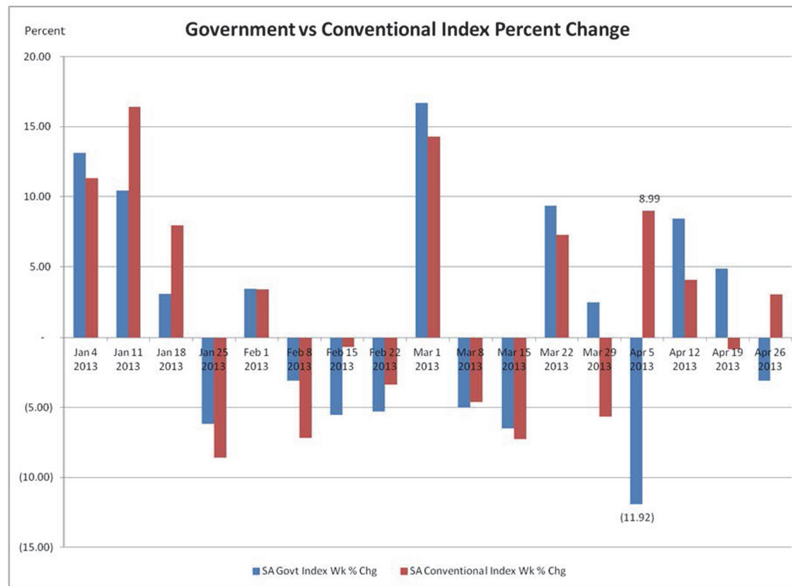
Q.5. Strengthening the 2 percent capital level.

A.5. Requiring a higher capital ratio would likely be difficult to achieve without disrupting the housing market and FHA's ability to carry out its mission. FHA currently has a negative capital ratio, and based on the FY2012 Actuarial Report, the MMI Fund is not expected to reach its required 2 percent capital reserve requirement until 2017. There are really only three ways that FHA can increase its net income and build this capital ratio: further increasing MIPs; tightening its credit standards further and thereby reducing its risk exposure; or reducing realized losses through better execution of loss mitigation programs, foreclosures and REO disposition. Certainly reducing realized losses through better execution of loss mitigation programs should be done, but that alone is unlikely to be sufficient to significantly improve the capital ratio. Tightening the credit box and increasing MIPs can only be done prospectively, and each of these would reduce the future volumes of new FHA loans, making it even more difficult to achieve to a capital ratio above 2 percent.

With the aforementioned impacts in mind, MBA is still evaluating the pros and cons of raising the statutory minimum capital ratio.

Q.6. The Federal Housing Administration (FHA) has raised premiums five times since 2009. What impact has that had on the market? Has it encouraged the return of private investment?

A.6. Increasing the cost of an FHA-insured loan through increases in the MIP have helped FHA to achieve its goal of reducing market share by encouraging market competition and the return of private sector lending. For example, applications for conventional mortgages gained 9 percent the week following the MIP increase on April 1, 2013, while applications for Government insured loans programs fell almost 12 percent the same week.



Stronger borrowers with mortgage credit options may choose the conventional market for mortgages because of better pricing, thus reducing FHA's footprint in the marketplace, which is one of the agency's stated goals.