M E M O R A N D U M

To: Members of the Committee on Financial Services

From: FSC Majority Staff

Date: October 24, 2013

Subject: October 29, 2013, Full Committee Hearing Entitled "The Federal Housing Administration: Implications of a $1.7 Billion Taxpayer Bailout"

On Tuesday, October 29, 2013, at 10:00 a.m. in room 2128 of the Rayburn House Office Building, the Committee on Financial Services will hold a hearing entitled "The Federal Housing Administration: Implications of a $1.7 Billion Taxpayer Bailout." The hearing will explore the health of the Federal Housing Administration's (FHA) Mutual Mortgage Insurance Fund (MMIF) and the implications of the FHA's September 27, 2013, announcement that it would require $1.7 billion in mandatory appropriation from the U.S. Treasury effective September 30, 2013. This will be a one-panel hearing with FHA Commissioner Carol Galante as the sole witness.

Concerns about the Solvency of the MMIF

The Federal Credit Reform Act of 1990 requires that at the end of each fiscal year, every government credit agency, which includes the FHA, must have sufficient reserves to cover one hundred percent of anticipated future losses. The FHA's MMIF programs, like all federal government direct-loan and loan-guarantee programs subject to the Federal Credit Reform Act, can take advantage of "permanent indefinite authority" to cover increases in costs for outstanding loans and loan guarantees. This authority allows the FHA access to U.S. Treasury funds, without Congressional approval, for any funds needed to balance its books. On September 27, 2013, the FHA announced that, for the first time in its history, it would take a mandatory appropriation from the U.S. Treasury of approximately $1.7 billion. The actual mandatory appropriation was $1.68 billion, after the agency's final review on September 30.

On February 14, 2013, the U.S. Government Accountability Office (GAO) designated FHA as a high risk agency in its 2013 HIGH RISK SERIES report, which is updated every two years at the beginning of each congress. In its section entitled, "Modernizing the U.S. Financial Regulatory System and Federal Role in Housing

Finance," GAO states that "a weakening in the performance of FHA-insured mortgages has heightened the possibility that FHA will require funding from the U.S. Treasury to help cover its costs on insurance issued to date."[1]

The Role of the Federal Housing Administration

The National Housing Act of 1934 established the FHA, which is housed within the Department of Housing and Urban Development (HUD), and gave it the mission of providing federal mortgage insurance in order to provide stability and liquidity in the market, broaden homeownership, protect lending institutions, and stimulate the building industry. Before the FHA was established, home mortgages did not exceed 50 percent of home values and were short-term, lasting no longer than five years. At the end of the fifth year, homeowners had to pay their mortgages in full or refinance. During the Great Depression, lenders were unable or unwilling to refinance loans that came due. As a result, many borrowers lost their homes and lenders lost money because property values declined significantly.

FHA's mortgage insurance program created the 20-year, fixed-rate mortgage, which ultimately expanded to a 30-year term and led to standardized mortgages. The FHA does not originate loans, but rather insures mortgages issued by banks and other lenders. The FHA is intended to be self-funded; premiums paid by homeowners for FHA mortgage insurance are used to cover losses when loans default.

During the housing boom of the mid-2000s, the FHA's share of the mortgage market fell precipitously and, by the end of 2006, stood at under two percent of mortgage originations (measured by dollar volume). As housing prices began to decline, lenders tightened their underwriting criteria and the FHA began playing a larger role in the mortgage market. The Congressional Research Service (CRS) reported that during FY 2010, the FHA guaranteed nearly 40 percent of mortgages originated or refinanced, which corresponds to approximately 1.1 million homebuyers. FY 2010 was the second time that the FHA insured more than 1 million homebuyers in a single year. In FY 2012, FHA insured nearly 1.2 million single-family mortgages in FY2012, nearly 734,000 (about 62%) of which were for home purchases, which was similar to FY 2011 statistics.

In terms of measuring the mortgage insurance market, as of the fourth quarter of 2012, the FHA's market share could be viewed as either 57.5% percent of all insured mortgages, based on the total number of loans, or, alternatively, 42.7 percent of all insured loans, based on dollar volume. According to the FHA, the federal mortgage insurance program currently insures more than $1 trillion worth of mortgages on more than 7 million loans.

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[1] U.S. GOV'T ACCOUNTABILITY OFFICE, HIGH RISK SERIES: AN UPDATE 84 (2013), *available at* http://gao.gov/assets/660/652133.pdf.

In recent years, more homebuyers have turned to FHA-insured loans to take advantage of its lower down-payment requirements, which are currently set at 3.5 percent of the property's appraised value. Larger down payments make it more difficult for first-time and low- or moderate-income homebuyers to purchase houses; thus, when banks and private mortgage insurance companies tightened their underwriting criteria and required down payments greater than 3.5 percent, many borrowers turned to FHA-insured mortgages as an alternative.[2]

At the same time that the FHA's market share has grown, the FHA—like most other participants in the mortgage market—faces higher default rates. The FHA thus finds itself supporting the mortgage market by insuring new home loans at the same time that it seeks to shore up the solvency of the MMIF, its single-family mortgage insurance fund. The MMIF's capital reserve ratio—which is a measure of the MMIF's strength—fell below the statutorily required two percent for the first time in FY 2010, to 0.50 percent. The two percent capital reserve ratio was established by the Omnibus Budget Reconciliation Act of 1990, at a time when many were concerned about the solvency of the FHA. The capital reserve ratio is defined as the MMIF's economic value divided by the total insurance-in-force. The FHA's ability to meet the two percent capital reserve requirement has historically been viewed as evidence of the strength and stability of its MMIF.

FHA's FY 2012 Actuarial Report and Health of Single-Family Insurance Fund

On November 16, 2012, HUD released the FHA's FY 2012 Actuarial Report, which reflected a marked year-over-year deterioration in the MMIF's capital reserve ratio. During FY 2012, the MMIF's capital reserve ratio fell to *negative* 1.44 percent, which means that the FHA does not have sufficient reserves to cover its expected losses. The FY 2012 Actuarial Report also noted that the MMIF's economic value was *negative* $16.3 billion, which is the projected amount the FHA would lose if it stopped insuring new mortgages and covered its projected losses. The MMIF's *negative* $16.3 billion economic value represents a decrease of $17.49 billion from its $1.19 billion economic value at the end of FY 2011, which resulted from further declines in national home prices, more loans having elevated default potential, and uncertain economic conditions.

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[2] DARRYL E. GETTER, CONGRESSIONAL RESEARCH SERVICE, FEDERAL HOUSING ADMINISTRATION (FHA) AND RISKY LENDING 3 (2010), *available at* http://www.crs.gov/pdfloader/R40937.