

Center for American Progress Action Fund



Sarah Rosen Wartell
Executive Vice President
Center for American Progress Action Fund

before

The Committee on Financial Services
United States House of Representatives

hearing on

“Perspectives on the Health of the FHA Single-family Insurance
Fund”

December 1, 2011

Good morning Chairman Bachus, Ranking Member Frank, and members of the committee. Thank you for the opportunity to testify today about the financial status of the Federal Housing Administration's Mutual Mortgage Insurance Fund. I applaud the chairman for convening this hearing to address this important topic.

I'd also like to take this opportunity to thank Ranking Member Frank for his more than 30 years of service in the U.S. Congress. Over the years, I have had the privilege of having my arguments tested and challenged by Rep. Frank a number of times and my positions were always much improved by his insights and razor-sharp questioning. I expect that after a productive year in the House in 2012, he will continue to challenge us all to do our best for American families from wherever he chooses to engage in the policy debate.

In the wake of the worst housing crisis in more than 80 years, concern has arisen that FHA could run out of money and require taxpayer support. Despite some inflated claims, today's FHA does still have adequate funds to cover all expected losses with a small additional reserve (under the most widely subscribed assumptions about home values) and is expected to get stronger in the coming years. FHA's immediate financial future, however, does rely upon stability in the U.S. housing market.

Let me begin by making a few central points on the financial status of FHA:

- Historically, FHA has played a central role in keeping liquidity available in the mortgage market in times of economic duress, as we are now observing firsthand. This role has been critical in the most recent crisis. Without FHA, more than a million homeowners likely would not have had access to mortgage credit in the wake of the financial crisis, which would have further chilled housing demand, further depressed home prices, and exacerbated the economic downturn.
- In fact, it is remarkable that FHA has not required supplemental support to date, given that so many of our private institutions needed temporary help to emerge from the crisis. FHA has so far weathered the worst housing collapse since the Great Depression—arguably in history—all while maintaining an insurance portfolio serving primarily low- and moderate-income borrowers and playing a key countercyclical role that has prevented a more devastating over-correction in the housing market. This is testament to the tools FHA has, where stronger books of business help cover losses from the earlier years.
- FHA's current financial position is the result primarily of significant losses in loans insured in the years immediately preceding the financial crisis. But its recent books of insured loans are projected to have significant net economic value to FHA.
- The capital reserves in FHA's Mutual Mortgage Insurance Fund—the insurance fund maintained by FHA to protect taxpayers from losses—are uncomfortably low, but under reasonable (although not certain) economic assumptions, FHA will be able to recapitalize the reserve without taxpayer support. More than anything else, FHA's

solvency depends on whether and the extent to which housing prices continue to fall in the next two years.

- Even if home prices continue to fall, FHA still has tools at its disposal to bolster its reserves without taxpayer dollars. In particular, FHA can make premium adjustments and can further tighten underwriting standards.
- In the future, I believe FHA should prioritize premium adjustments over higher down payment requirements. Historically low interest rates leave room for borrowers to absorb slightly higher fees without creating an affordability barrier to access. In contrast, higher underwriting standards and higher down payment requirements, on top of existing tightened standards, could make it difficult for a broad swath of homeowners to obtain mortgages, putting further downward pressure on housing demand and thus contributing to continued home-price weakness and further risk to the MMI Fund.
- As we move toward a new system of housing finance that works for American families, FHA will continue to be a critical source for mortgage capital in underserved sectors of the market. Congress should consider long-term reforms to equip FHA with the talent, resources, and authority in needs to adapt quickly and nimbly to market changes, helping it better manage taxpayer exposure to risk.
- Risk sharing is another promising way FHA can limit its exposure. Full insurance coverage is necessary in many areas of FHA business, but under certain conditions and with some products the government may be able to reduce risks by taking advantage of the private sector's risk assessment and mitigation capacities.

Historically and today, FHA plays a critical role in providing liquidity in the mortgage market during times of economic stress.

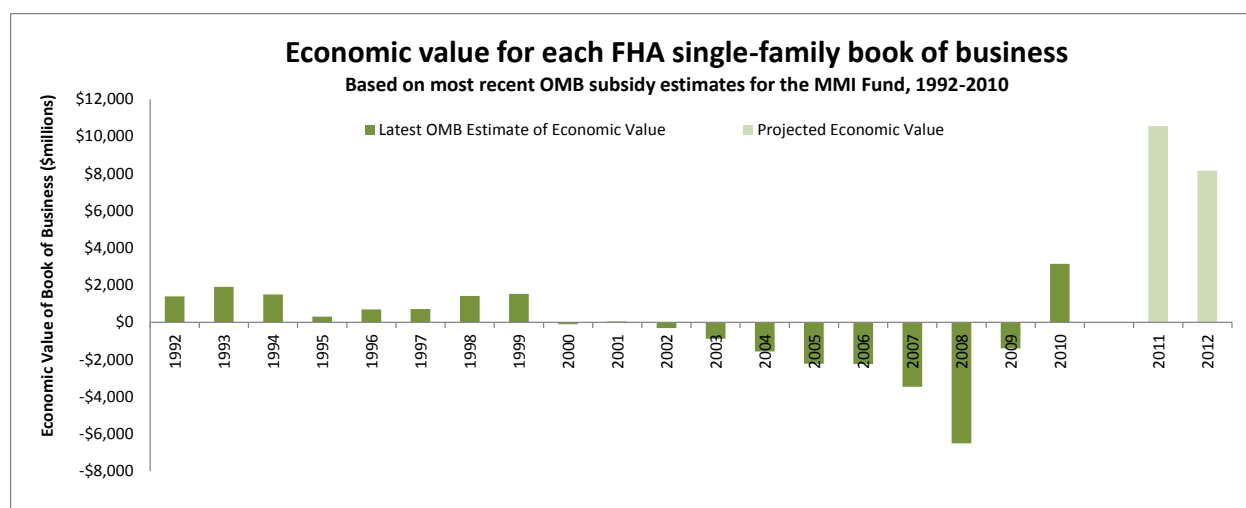
Before I discuss FHA's current financial condition, it's important to put today's situation in historical context. The Federal Housing Administration was established in 1934 to help promote long-term stability in the U.S. housing market. For close to 80 years, FHA consistently maintained a small but meaningful share of the market, focusing on first-time homebuyers and creditworthy low- and moderate-income borrowers. FHA was also integral to creating and popularizing the 30-year fixed-rate self-amortizing mortgage, now a pillar of U.S. housing finance.

Together with Ginnie Mae, which facilitated secondary market access for FHA-insured loans, FHA's guarantee of mortgage debt helped to ensure that credit was continuously available under terms and at prices that made sustainable homeownership possible for many American families.¹ To date, FHA has accomplished these goals at little to no cost to taxpayers.²

A key way FHA promotes stability in the market is by providing countercyclical liquidity, today as in 1934. When private capital withdraws from the housing market in uncertain economic conditions, FHA expands its activities to ensuring mortgage capital remains available and

American families can find buyers for their homes. To insulate itself from the increased risks it is taking, FHA has historically tended to tighten its underwriting standards or raise premiums during these countercyclical periods when its market share is expanding.

By the very nature of its activities, including providing countercyclical liquidity, FHA's business does not always maximize profits. Some books of business yield a positive economic value, while others have a negative value. In simple terms, FHA's long-term financial health depends on building a strong capital cushion from well-performing books so that it can continue to reach underserved borrowers and to do business in stressful periods when other credit providers withdraw.



FHA's role during the so-called "oil patch" contraction of the 1980s is a good example of how it provides countercyclical liquidity. After years of rapid growth fueled by booming oil prices, states like Texas, Louisiana, and Alaska fell into a deep recession in the early 1980s when the oil market began to tumble, leading to a collapse in local housing markets. Following the historical trend, private lenders responded by withdrawing from these markets, threatening to turn a housing downturn into a severe bust, with dire economic consequences for these regions. During this period, FHA played a critical role by significantly increasing its mortgage insurance activities, helping to ensure that sufficient liquidity remained available and that problems in these regional housing markets did not lead to more dire economic problems.

But of course, providing this countercyclical liquidity to troubled housing markets had the effect of adding significant new risk to FHA's portfolio. Nearly half of the claims FHA paid out on loans originated in 1985 to 1986 came from the oil patch states of Texas, Oklahoma, Louisiana, Colorado, and Alaska, according to *Mortgage Banking*.³ And FHA would insure more mortgages between 1986 and 1990 than it did in the previous 13 years combined.

FHA responded to this increased risk by tightening its underwriting standards with over 30 measures, including stricter compensating factors for borrowers above credit ratio guidelines.⁴ These measures were quite successful in mitigating the potential risks that FHA took on during its period. By the early 1990s the oil patch states recovered, FHA's market share returned to

historic norms, and the agency managed to build up its capital reserve without help from taxpayers.

The problem FHA faces today is in many ways similar to the oil-patch recession, albeit much more pronounced and on a much larger, and more national, scale.

Starting in the late 1990s and early 2000s, new private mortgage products and providers emerged to target the budding subprime and Alt-A markets. Many of these products competed directly with FHA insurance programs, often with artificially low prices based on an underestimate of the true risk of the underlying loans.

Ironically, and contrary to the conclusions of many of the critics of the government's role in mortgage finance, the private sector was actually significantly worse at pricing risk than the government during the recent housing bubble. This underpricing of risk gave privately originated subprime and other exotic mortgages a competitive edge over more traditional products, such as FHA-insured mortgages. They also enabled the loan brokers to make much larger upfront fees than with traditional FHA loans.

As private subprime lending took over the market for low- and moderate-income borrowers, FHA saw its market share plummet in the mid-2000s. In 2001 FHA insured 14 percent of home purchase loans. By 2005 that number shrank to 4 percent.⁵

The rest of the story is well known: The influx of new and largely unregulated private subprime lending contributed (along with other factors) to a massive bubble in the U.S. housing market. By 2008 the bubble had burst in a flood of defaults, leading to a near collapse of the American mortgage market. Mortgage giants Fannie Mae and Freddie Mac were placed under government conservatorship and significantly tightened their underwriting standards, conventional lenders pulled back, and subprime lending essentially came to a halt.

True to its role to provide countercyclical liquidity, FHA's lending activity surged to fill the gap left by the moribund non-agency mortgage market and constrained agency business. In 2009 FHA insured 56 percent of home purchases and about 35 percent of all mortgage loans (home purchases and refinances), a level not seen since World War II.

If FHA had not stepped in, increasing activity more than fourfold between 2007 and 2009, the housing market would be in much worse shape than it is today. Without FHA hundreds of thousands—perhaps even millions—of homebuyers would not have purchased houses over the past three years, shut out of the market because of a lack of available finance. And the 56 percent of all first-time buyers⁶ and 60 percent of all African American and Latino homebuyers⁷ that rely on FHA financing today likely would have had nowhere else to turn when private lenders tightened their underwriting standards.

Families that needed to move for new employment or to finance retirement would have found few buyers, the glut of unsold properties would have grown larger yet, and many more families would have found their mortgages underwater. And the further decline in real wealth would have chilled economic activity even further.

FHA's current financial position is the result primarily of significant losses in loans insured in the years immediately preceding the financial crisis. But its recent books of insured loans are projected to have significant net economic value to FHA.

Before we look to the future, it's important to understand the highest risks in FHA's current insurance portfolio. FHA continues to suffer big losses from higher-than-expected foreclosure rates on mortgages insured before the bubble burst, particularly in its 2006 and 2007 books of businesses. As private actors began to withdraw from some market segments, originators turned to FHA to sustain their volume, before FHA put in place appropriate controls to stem risks in this new business.

FHA's independent actuaries, Integrated Financial Engineering, Inc., predict as many as half of all low-FICO score and high-loan-to-value loans insured at the peak of the housing bubble will ultimately result in loss for FHA. They also estimate more than 1 out of every 4 loans insured in 2007 alone will result in an insurance claim.⁸

Books from the mid-2000s also carry unexpected risks due a high number of loans with little or no borrower-paid down payments. Prior to 2008, FHA endorsed a large number of so-called "seller-financed down payment assistance loans," in which sellers covered the required down payment at the time of purchase in exchange for inflated purchase prices. These loans experienced claim rates that are considerably higher than otherwise comparable non-assisted loans, according to the actuarial report.⁹ These often-fraudulent assistance programs were later banned from FHA insurance programs by the Housing and Economic Recovery Act of 2008.

Starting in 2001 there was also a rapid increase in the share of loans with "gift" down payment assistance from nonprofit, religious, or community institutions, increasing to almost 25 percent of FHA loans in the 2005, 2006, and 2007 books of business. These loans have performed worse than loans with no form of down payment assistance, making claim risks for these books particularly high, according to the actuarial report.¹⁰

As an example, loans with "gifts" from nonprofit organizations in the 2005 book had a claim rate of about 17 percent, while loans with no down payment assistance in that book had a claim rate of less than 7 percent.¹¹

To be sure, many nonprofits, states, and local governments provide essential down payment assistance that does not meaningfully affect the borrower's risk of default. It's also worth noting that several "nonprofits" issuing this assistance were in fact fronts for developers and sellers. So while certain types of assistance may negatively impact the economic value FHA's books, it does not necessarily mean that these programs should be scaled back.

And as bad as these rates are, they are much better than the rates for private subprime lending during this period. By comparison, more than 20 percent of subprime loans originated in 2006 and 2007 defaulted within 12 months, according to the Federal Reserve Bank of Chicago.¹²

While losses from these pre-crisis books will likely continue for several years, FHA's post-crisis books are expected to have significant positive net economic value, due in part to increased fees

and tightened underwriting standards. The 2011 book, for example, is expected to bolster the MMI fund's reserves by \$10.5 billion, while the new 2012 book of business is projected to add another \$8.1 billion, according to the actuarial report.¹³

FHA currently insures about a third of all home loan purchases in the United States, well above historic norms. As the housing market recovers, FHA's share should and will return to its historical norms. But as long as the current housing crisis continues, and private mortgage lenders continue to stay on the sidelines, FHA will continue remain a critical option for ensuring that affordable mortgage capital remains available for potential homebuyers.

The capital reserves in the MMI Fund are uncomfortably low, but under reasonable although not certain economic assumptions FHA will be able to recapitalize the reserve without taxpayer support.

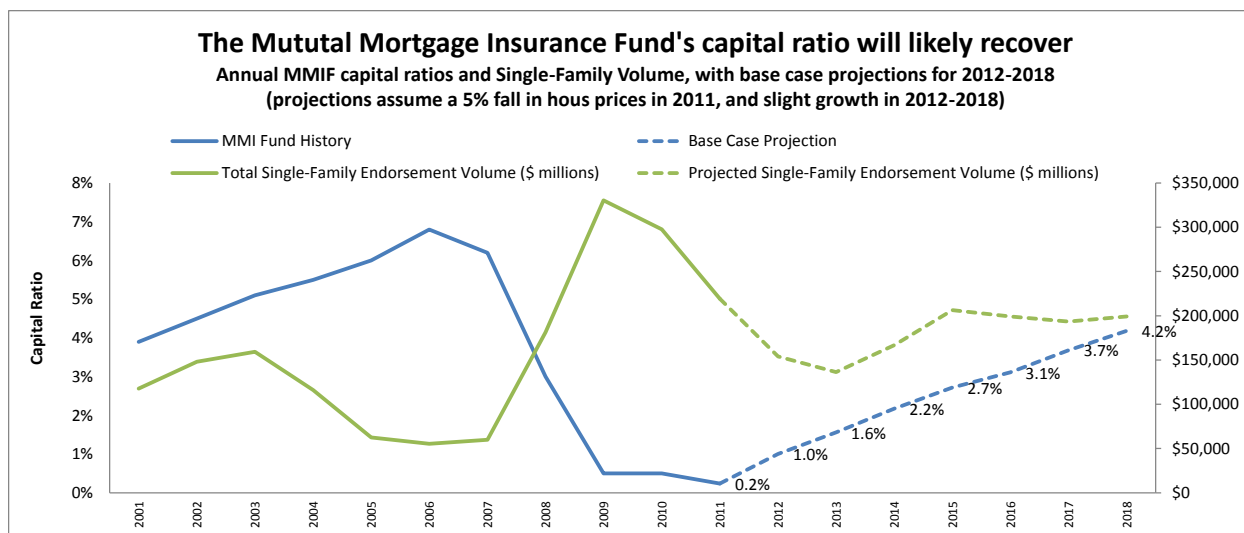
FHA recently released its annual financial report and independent actuarial review for the MMI Fund, which covers virtually all of the agency's single-family insurance programs. Most of the numbers I cite in this testimony come directly from those reports.

The most closely-watched statistic in the financial report is the so-called "capital ratio," the amount of excess cash the agency has on hand to cover unexpected insurance claims, reported as a percentage of total insurance in-force. For the past 20 years, Congress has mandated that FHA maintain a capital ratio of 2 percent, meaning it keeps an extra \$2 on reserve for every \$100 of insurance liability. The MMI fund's current capital ratio is just 0.24 percent, about an eighth of the legal threshold, according to the report.¹⁴

This is a serious problem, but not one that should be overstated. First, it's important to understand what exactly we're talking about here. As required by law, the MMI Fund still holds about \$30 billion in its so-called "financing account" to cover all expected insurance claims over the next 30 years. The capital ratio measures the *additional* cash reserves to cover any *unexpected* losses beyond this reserve for expected losses.¹⁵

So even when that ratio falls below the 2 percent threshold, FHA still has cash on hand to cover its immediate insurance liabilities. Think of it as the difference between a checking account you use to pay your bills and a savings account you keep tucked away for a rainy day.

Secondly, while the MMI Fund's capital ratio is currently uncomfortably low, it will likely recover in the coming years, even if the current malaise in the housing market continues. FHA predicts the ratio will return to the 2 percent threshold by 2014, assuming a 5 percent fall in house prices in 2011 and a slight rebound in subsequent years.¹⁶ The predicted recovery is attributable to the high expected economic value of the 2010 through 2012 books of business.



Under the same assumptions described above, FHA's actuaries expect the economic value of the MMI fund—the amount of excess cash on hand to cover unexpected claims—to rise by an average of \$8.3 billion per year through 2018. The fund's capital reserve is projected to increase from its current level of \$1.2 billion to about \$60 billion over the next seven years.¹⁷

If that indeed turns out to be the case, it would be quite a remarkable accomplishment for FHA. The agency will have weathered the worst housing crisis since the Great Depression—arguably in history—without a government bailout, all while maintaining an insurance portfolio that largely targets low- and moderate-income borrowers. We should all be grateful for FHA, for without it the housing market—and the economy as a whole—would be in much worse shape than it is today.

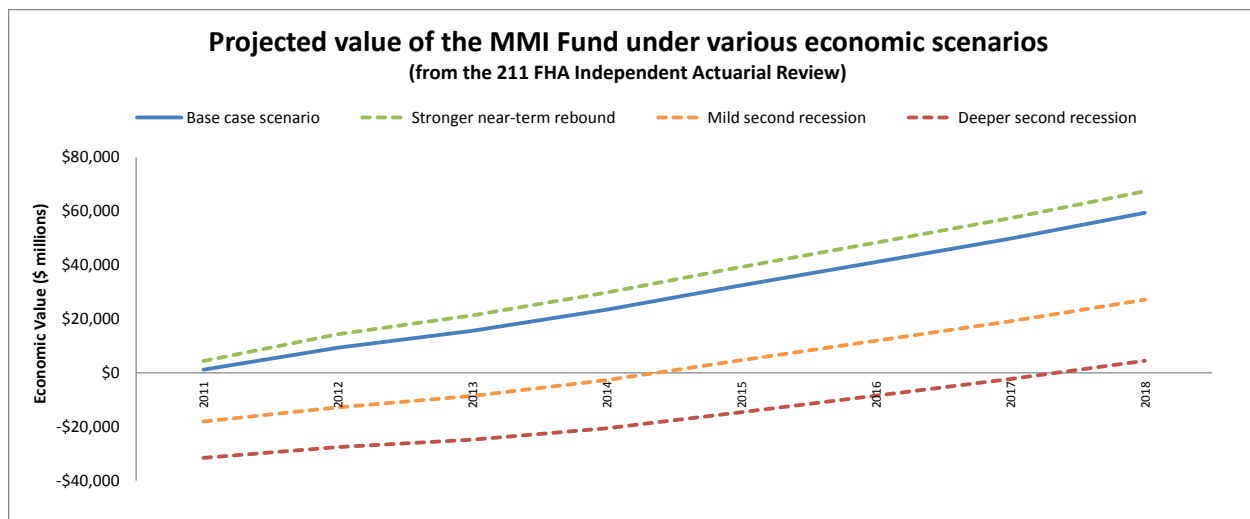
Of course, all of the above predictions assume a relatively stable housing market in the coming years. Like most private insurers, FHA's performance is heavily dependent on the health of the sector it insures: housing, and particularly fluctuations in home values. When home prices fall, borrowers who suffer unemployment or other shocks are more likely to default on their mortgages, and FHA also recovers less in the event of a default. Both factors result in bigger losses for FHA.

Which brings us to the multibillion-dollar question before us today: What happens to the MMI Fund if housing prices fall significantly again?

According to FHA's financial report, if home prices fall another 9 percent over the next two years, the MMI Fund's capital reserve will likely run dry, meaning FHA will no longer have reserves for unexpected future claims. Such a scenario, if measures are not taken in advance to bring in more revenue, could force FHA to seek taxpayer dollars for the first time in its 77-year history.¹⁸

The independent actuarial review confirms that under more pessimistic economic scenarios, in which the housing market enters into a "mild second recession," the MMI Fund could have a "negative economic value" by the end of this fiscal year, meaning it will not even have enough

cash to cover all expected future claims. And in the case of a “deeper second recession,” the MMI Fund’s capital reserves could be as much as \$31.5 billion in the red by the end of the year.¹⁹



It’s worth noting that the worst two-year period recorded by the Federal Housing Finance Agency was at the height of the housing crisis, when prices fell just under 13 percent between the second quarter of 2007 and the second quarter of 2009.²⁰ And housing prices nationally are already down about 30 percent from their peak in 2006, and in some hard-hit communities it’s closer to 50 percent.²¹

With house prices having already fallen quite far, many notable economists predict home prices will bottom out sometime next year and start rising modestly in 2012, including forecasters at Freddie Mac,²² Moody's Analytics,²³ the National Association of Realtors,²⁴ the Mortgage Bankers Association,²⁵ and Fiserv.²⁶

To be sure, other forecasters are less optimistic, but very few predict another double-digit drop in the coming years. For example, the real estate firm Zillow expects prices to decline another 3 to 5 percent before reaching a definitive bottom in 2012 “at the earliest.”²⁷ And PIMCO recently estimated that U.S. home prices may drop another 6 to 8 percent before they hit bottom.²⁸ All things considered, FHA’s actuaries estimate about a 50-50 chance the MMI Fund will maintain a positive capital reserve in the coming years, with no policy changes.²⁹

If home prices do not turn around soon, FHA still has tools at its disposal to bolster its reserves without taxpayer dollars.

No one can be certain what will happen in the housing market over the next few years, but that hasn’t stopped some analysts from sounding the alarm of an impending FHA bailout. A recent report from Joseph Gyourko of the Wharton School, commissioned by the American Enterprise Institute, predicted FHA will require recapitalization of “at least \$50 billion, and likely much more,” even if housing markets do not deteriorate severely. Only “quick and substantial

economic and housing market recovery," Gyourko writes, is the "primary way for FHA to avoid generating substantial losses for American taxpayers."³⁰

But Gyourko's analysis overstates the case. First, his \$50 billion number is an estimate of the total capital necessary for the MMI fund to meet the required 2 percent ratio. This estimate disregards the nature of that countercyclical mandate, especially during times of economic duress.

Title II, Section 207 of the 1990 Cranston-Gonzalez National Affordable Housing Act states that FHA should have a "capital ratio goal of at least 2 percent." When the ratio falls below that level, the secretary of Housing and Urban Development must "advise the Congress of any administrative measures being taken to attain and maintain a capital ratio of at least 1.25 percent, and make any legislative recommendations that the Secretary deems appropriate."³¹

In other words, FHA need not regenerate its capital reserves in one fell swoop. By law, the HUD secretary is required only to come up with a viable recapitalization plan.

When Congress instituted the capital ratio requirement in 1990, it gave HUD ten years to increase its capital from zero to 2 percent. It took only three years for FHA to reach the threshold, thanks in part to increased insurance premiums.³² This is an example of how countercyclical capital works, in contrast to the pro-cyclical tendencies that characterize the private mortgage market and have brought us both boom and bust.

FHA has already taken many of the necessary steps to bolster its capital reserves. For starters, FHA has increased insurance premiums three times since 2009 to the highest levels in its history. The new premium structure alone increased the economic value of the 2011 book by \$1.37 billion, according to the annual financial report.³³

The agency has also significantly tightened underwriting standards. Under new rules, borrowers with FICO scores below 580 are now required to put down a minimum down payment of 10 percent, or have equity of 10 percent at the time of refinance. Only borrowers with stronger credit are eligible for FHA-insured mortgages with the minimum 3.5 percent down payment.

FHA purchase mortgage insurance continues to be a low down-payment business, with 85 percent of loans insured in 2011 having down payments of less than five percent; in recent years, however, FHA has taken steps to control the source of those payments, particularly by reducing the number of risky seller-funded down payment loans. While sellers funded 37 percent of FHA down payments in the first quarter of 2008, there were virtually none in the 2010 and 2011 books of business. Three quarters of down payments were made with borrower funds in 2011, compared to less than 45 percent in the first quarter of 2008.³⁴

Tightened standards—and the lack of available private-market alternatives for many borrowers—means that FHA borrowers now have much better credit than in previous years. Nearly half of FHA borrowers had FICO scores below 620 in 2007; for the 2010 and 2011 books of business, only 3 percent of borrowers were below that threshold. For the first time in the

agency's history, more than half of FHA borrowers had a FICO score of more than 700, according to the annual report.³⁵

FHA has also overhauled its single-family loan review policies and procedures, resulting in a number of changes to strengthen monitoring of FHA lenders.³⁶ HUD also now requires FHA-approved lenders to have a net worth of at least \$1 million.³⁷

Loan delinquencies and defaults have declined dramatically in recent months. The single-family portfolio's ninety-day delinquency rate, often the first indication of strength or weakness of new insurance commitments, was just 0.3 percent in early 2011, a new post-crisis low. As a comparison, that so-called "early-period" delinquency rate was more than eight times higher at the peak of the foreclosure crisis in 2007.³⁸

The portfolio's "serious" delinquency rate, which tracks delinquencies after 90 days, has also declined steadily for the past two years, from 9.44 percent in early 2010 to 8.18 percent in the third quarter of 2011. And the quality of FHA's loan portfolio seems to have improved since the crisis: serious delinquency rates for the 2009 and 2010 books of business are substantially lower rates than the 2006-2008 books.³⁹

In the future, FHA should prioritize premium adjustments over further tightening underwriting standards. If we place undue restrictions on FHA it could create additional weakness in the housing market, potentially also hurting the health of FHA.

Depending on what happens with home prices in the near future, FHA may need to take further steps to bolster its capital reserves. FHA traditionally does this by either tightening underwriting standards or by adjusting premiums. If further measures are required, I urge FHA to prioritize premium adjustments over further tightening underwriting requirements, especially overly tightening loan-to-value ratios.

The primary benefit of upfront premium increases is that they quickly generate revenue to the MMI Fund; the benefit of reduced claims from tightened underwriting is felt over a longer period, by which time, the MMI Fund may well have recovered, as current and future year larger books of business with projected positive net economic value would have matured and bolstered the fund.

In addition, at a time of historically low mortgage rates, there is room for FHA to increase its fees without having a meaningful impact on access to credit. This is especially the case for large-size FHA loans, which currently play a larger role in FHA business than in other periods. One option would be to differentiate premiums so that higher loan amount mortgages pay higher premiums.

However, further tightening underwriting standards, especially by increasing minimum down payments, will likely reduce both FHA's volume and the overall size of the mortgage market and put downward pressure on home values – limiting FHA's ability to play the countercyclical role. This could negatively affect FHA's financial health in the long run, as the agency is so

dependent on the health of the housing market. And a strong housing market mitigates taxpayer exposure to risk through losses from Fannie Mae and Freddie Mac.

Furthermore, these decisions would be in tension with FHA's mission to support communities especially hard-hit by the foreclosure crisis, many of which saw significant home equity stripped by subprime and predatory lending. In these neighborhoods, without reasonable access to FHA, housing markets would be stagnant and the prospects of recovery would diminish.

Other reforms could help strengthen FHA and better equip it to protect taxpayers from risk.

FHA has the capacity to make tough decisions and some statutory flexibility to adjust its risk exposure to protect the taxpayers. But Congress must make sure FHA also has the resources it needs to soundly manage a \$1 trillion insurance portfolio.

I have long been a proponent of plans to modernize FHA into a modern financial institution with the staff, systems, and authority to adapt quickly to market changes, helping it better manage taxpayer exposure to risk. This will likely require significant structural and operational reforms, starting with the staff.

A recent GAO report found that while FHA business volume and workloads have increased significantly in recent years, staffing levels have stayed about the same.⁴⁰ This is not just a numbers issue; it's also a matter of skill and relevant market experience. While federal financial regulators like FDIC and SEC are allowed to pay appropriate salaries for employees with special skills, FHA salaries are subject to lower federal-employee caps. I believe Congress should reconsider these restrictions.

In addition according to FHA's 2010 actuarial report, the agency's "current financial system is comprised of numerous aging information systems developed independently over the last thirty years," which will "continue to require expensive maintenance and monitoring and are likely to pose increasing risks to the reliability of FHA's financial reporting and business operations."⁴¹

FHA deserves credit for launching the "FHA Transformation Initiative," a multi-year effort to acquire and employ a modern financial services information technology environment.⁴²

Appropriate levels of funding in the coming years will be required to ensure that improvements are made that protect taxpayers.

Risk sharing is another promising way FHA can limit its risk exposure. Most FHA programs offer 100-percent government insurance. Full coverage may be needed during periods of market stress, when private capital is reluctant to take housing risk, or when serving underserved populations and pioneering new products. However, in some circumstances and with some products, the government may be able to reduce its exposure through a variety of risk-sharing structures that align the interests of private actors and the taxpayer and so take advantage of private sector risk assessment and mitigation capacities. I urge Congress to consider granting FHA more flexible risk-sharing authority so it can determine when risk sharing is appropriate for its single-family business.

I know from my experience at FHA from 1993 to 1998 how extraordinarily challenging it can be to make restructuring, personnel, systems, and product changes at FHA. The barriers to reforms that would both reduce FHA risk and improve its effectiveness are significant.

So I encourage the Congress to reconsider, as part of overall housing finance reform, a proposal first put forth by Secretary Henry Cisneros during his tenure at HUD.⁴³ That proposal would have transformed FHA into a more nimble but disciplined government corporation, with strict and independent oversight of its performance in serving underserved markets and maintaining financial soundness, but greater flexibility in product design and personnel, among other factors, to meet those ends. Similar recommendations were endorsed by the Millennial Housing Commission in their report submitted to Congress in May 2002.⁴⁴

For more than 75 years, FHA has helped to provide liquidity and enhance stability in the U.S. mortgage market. Emerging from the Great Depression, it transformed housing finance by demonstrating how long-term, fixed-rate mortgages can help middle-class families better plan for the future in uncertain economic times. Despite its current financial difficulties, FHA has played an important role in improving the economic condition of everyday American families at a uniquely challenging time in our history.

FHA is and will continue to be a critical part of an effective U.S. housing market under any version of a reformed system under consideration. But its future role very much depends on how Congress and the administration decide to wind down the government-sponsored enterprises, Fannie Mae and Freddie Mac, currently in government conservatorship and build a new housing finance system built in their place. On the one hand, if Congress strips all government support from the market formerly covered by the GSEs, FHA will likely be forced to maintain or even grow its substantial market share.

On the other hand, if the government maintains an explicit guarantee on certain types of mortgage debt and charges for its backstop so it can hold actuarially sound reserves against its obligations—much like the proposal released by CAP’s Mortgage Finance Working Group⁴⁵—FHA will be able to return to a more manageable share of the market when prices stabilize.

FHA’s immediate financial future is inextricably linked to the health of the housing sector—and the economy as a whole—in the coming years, and the recent financial reports remind us just how vulnerable FHA is to broader economic conditions. But this warning should not be overblown; with prudent management, there’s still a good chance the agency will weather the steepest housing downturn since its creation without taxpayer support.

Helping the housing market recover and growing the economy must be a top priority for Congress and the Obama administration. With a stronger economy and housing market, FHA’s current financial condition will likely improve on its own.

In closing, I would like to commend the chairman and the other members of this committee for attention to this important topic. If the recent financial crisis taught us anything, it's that we must closely monitor the business practices and actuarial health of our essential financial institutions. Congress and FHA officials together can ensure that FHA continues to play its essential role while protecting the taxpayers.

Thank you. I would be happy to take any questions.

ENDNOTES

¹ The Mortgage Finance Working Group, sponsored by the Center for American Progress, “A Responsible Market for Housing Finance” (Washington: Center for American Progress, 2011). Available at http://www.americanprogress.org/issues/2011/01/responsible_market.htmlp1.

² FHA does not keep the revenues generated by its insurance programs; they are deposited back into the Treasury. Each year, FHA receives a small appropriation for operational expenses - Congress appropriated \$188,900,000 to the FHA Mutual Mortgage Insurance Fund for fiscal Year 2011 - but much or all of that was funded by FHA’s excess revenues from previous years. (See http://portal.hud.gov/hudportal/documents/huddoc?id=FHA_Fund_MMI_Fund_2_2012.pdf)

³ Brian Chapelle, “The FHA Facts,” Mortgage Bankers Magazine, October 1, 1991, p. 89. Available at http://findarticles.com/p/articles/mi_hb5246/is_n1_v52/ai_n28607867/?tag=content;col1

⁴ IBID.

⁵ Federal Housing Administration, FHA Single Family Activity in the Home-Purchase Market Through June 2011, (U.S. Department of Housing and Urban Development 2011), p. 1-2, Tables 1 and 2. Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=fhamkt0611.pdf>

⁶ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011), p. 12. Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY11No2.pdf>

⁷ Ibid, p. 10.

⁸ Raphael Bostic, “The Continued Strength of the FHA,” U.S. Department of Housing and Urban Development Official Blog, November 18, 2011, Available at <http://blog.hud.gov/2011/11/18/continued-strength-fha/>

⁹ Integrated Financial Engineering, Inc., *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year*. (U.S. Department of Housing and Urban Development 2011), p. vi. Available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu

¹⁰ Ibid, p. 44.

¹¹ Ibid, p. 45.

¹² Gene Amromin and Anna L. Paulson, “Default rates on prime and subprime mortgages: differences and similarities,” *Profitwise News and Views*, September 2010, p. 1. Available at http://www.chicagofed.org/digital_assets/publications/profitwise_news_and_views/2010/PNV_Aug2010_ReEd_FINAL_web.pdf

¹³ Integrated Financial Engineering, Inc., *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year*. (U.S. Department of Housing and Urban Development 2011), p. ii. Available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu

¹⁴ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011). Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY2011.pdf>

¹⁵ David H. Stevens Assistant Secretary for Housing/FHA Commissioner U.S. Department of Housing and Urban Development, Testimony before the Subcommittee on Housing and Community Opportunity, “FHA Capital Reserve Ratio,” October 8, 2009, p. 2. Available at http://www.house.gov/apps/list/hearing/financialsvcs_dem/stevens_testimony_-_hud.pdf

¹⁶ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011). Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY2011.pdf>

-
- ¹⁷ Integrated Financial Engineering, Inc., *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year*. (U.S. Department of Housing and Urban Development 2011). Available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu
- ¹⁸ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011). Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY2011.pdf>
- ¹⁹ Integrated Financial Engineering, Inc., *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year*. (U.S. Department of Housing and Urban Development 2011). Available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/actr/actrmenu
- ²⁰ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011). Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FinStatFHAMMIFundFY11.pdf>
- ²¹ S&P Indices, "Home Prices Weaken as the Third Quarter of 2011 Ends According to the S&P/Case-Shiller Home Price Indices," Press Release, November 29, 2011. Available at <http://www.standardandpoors.com/indices/articles/en/us/?articleType=PDF&assetID=1245324826884>
- ²² Freddie Mac, "November 2011 Economic Outlook," (2011). Available at http://www.freddiemac.com/news/finance/docs/Nov_2011_public_outlook.pdf
- ²³ <http://www.reuters.com/article/2011/06/20/us-property-summit-zandi-prices-idUSTRE75J6KD20110620>
- ²⁴ Helen Chernikoff, "Zandi sees earliest U.S. home price rise end: 2012." *Reuters*, June 20, 2011. Available at <http://www.reuters.com/article/2011/06/20/us-property-summit-zandi-prices-idUSTRE75J6KD20110620>
- ²⁵ National Association of Realtors, "U.S. Economic Outlook: November 2011," (2011). Available at http://www.realtor.org/wps/wcm/connect/d12b538048d5547f8831cc2e39654e23/November_2011_Outlook.pdf?MOD=AJPERES&CACHEID=d12b538048d5547f8831cc2e39654e23
- ²⁶ Mortgage Bankers Association, "MBA Mortgage Finance Forecast," (2011). Available at <http://www.mortgagebankers.org/files/Bulletin/InternalResource/78526.pdf>
- ²⁷ Fiserv, "Fiserv Case-Shiller Home Price Insights: Greater Affordability and Strengthening Economy Restoring Price Stability to U.S. Housing Market," Press Release, November 9, 2011. Available at <http://investors.fiserv.com/releasedetail.cfm?ReleaseID=622254>
- ²⁸ Zillow, "Real estate Market Report," (2011). Available at http://www.zillow.com/blog/research/files/2011/07/Q3-Real-Estate-Report_FINAL-Dayof.pdf
- ²⁹ Scott Simon, "With Housing Fragile, the Risks of Public Policy Error Are High," *PIMCO*, June 2011. Available at <http://www.pimco.com/EN/Insights/Pages/With-Housing-Fragile-the-Risks-of-Public-Policy-Error-Are-High.aspx>
- ³⁰ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011), p. 53. Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY11No2.pdf>
- ³¹ *Cranston-Gonzalez National Affordable Housing Act*, S.566, 101st Cong. (Government Printing Office, 1990)
- ³² Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011), p. 43. Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY2011.pdf>

³³ In April of 2010, the upfront mortgage insurance premium was raised to 2.25 percent. In October 2010, using new flexibility granted by Congress, FHA decreased the upfront MIP to 1% and increased the annual MIP by 35 basis points. In April of 2011, the annual MIP was increased once again by 25 basis points. Information available at

<http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY11No2.pdf> p53.

³⁴ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011), p. 8. Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY11No2.pdf>

³⁵ Raphael Bostic, "The Continued Strength of the FHA," U.S. Department of Housing and Urban Development Official Blog, November 18, 2011, Available at <http://blog.hud.gov/2011/11/18/continued-strength-fha/>

³⁶ Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011). Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FinStatFHAMMIFundFY11.pdf>

³⁷ Lenders that meet the small business size standard set by the Small Business Administration are required to have a net worth of \$500,000. Information available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY11No2.pdf> p54.

³⁸ Federal Housing Administration, *Quarterly Report to Congress*, (U.S. Department of Housing and Urban Development 2011), p. 20. Available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts rtc/fhartcqtrly

³⁹ Federal Housing Administration, *Quarterly Report to Congress*, (U.S. Department of Housing and Urban Development 2011), p. 18. Available at http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts rtc/fhartcqtrly

⁴⁰ Government Accountability Office, "Federal Housing Administration: Improvements Needed in Risk Assessment and Human Capital Management," GAO-12-15, Report to the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, November 2011, p. 7. Available at <http://www.gao.gov/new.items/d1215.pdf>

⁴¹ Clifton Gunderson LLP, "Audit of the Federal Housing Administration's Financial Statements for Fiscal Years 2010 and 2009," (2010), p. 7. Available at <http://www.hudoig.gov/pdf/Internal/2011/ig11f0002.pdf>

⁴² Federal Housing Administration, *Annual Report to Congress: Fiscal year 2011 Financial Status FHA Mutual Mortgage Insurance*. (U.S. Department of Housing and Urban Development 2011), p. 57. Available at <http://portal.hud.gov/hudportal/documents/huddoc?id=FHAMMIFundAnnRptFY11No2.pdf>

⁴³ See *HUD Reinvention: From Blueprint to Action* (Department of Housing and Urban Development, 1995).

⁴⁴ The Millennial Housing Commission, "Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission Appointed by the Congress of the United States" (2002). Available at <http://govinfo.library.unt.edu/mhc/MHCReport.pdf>.

⁴⁵ For more on the MFWG plan, see http://www.americanprogress.org/issues/2011/01/responsible_market.html.