TESTIMONY

Establishing the Proper Role of the Federal Housing Administration in The U.S. Mortgage -Finance System

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Before the

Committee on Financial Services

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It is an honor to appear before this Committee today at its first hearing of the 113th Congress under the leadership of Chairman Hensarling and Ranking Member Waters to testify on the proper role of the Federal Housing Administration (FHA) single-family mortgage insurance program in the U.S. mortgage-finance system. FHA plays a vital role, but it may well supplant private capital that can and should be deployed to reduce taxpayer risk in a vital sector: low down-payment mortgage loans for first-time homebuyers and others without the equity to purchase a home, refinance an existing loan that is now high loan-to-value or "move up" in a prudent fashion. Further, FHA is just one element in the U.S. Government's role and its risk related to residential mortgage finance. In your request for testimony today, the Committee rightly made clear that setting the right role for FHA must be done with a clear vision of the overall stand the federal government will play in residential mortgage finance. Like I think most if not all Members of this Committee, I believe the taxpayer should take as little risk in this sector as possible, standing back now that the crisis is ebbing to permit private capital to re-enter this sector under a new regulatory framework robust enough to prevent past abuse of borrowers and investors.

I am Basil N. Petrou, managing partner of Federal Financial Analytics, a firm that provides consulting services on, among other things, the array of policy issues affecting single-family residential mortgage finance.[1] As the Committee has requested, I will focus my remarks today on whether FHA's 100 percent federal guarantee distorts mortgages in the U.S. financial system, if high-income borrowers who otherwise would be eligible for privately-insured loans should still avail themselves of FHA-insured loans and on policies that thwart efforts by the private sector to revive and strengthen their role in this vital arena.

Because the Committee has rightly noted that FHA reform is only one element of urgently-needed broader housing-finance reform, I will briefly summarize the relationship of FHA not just to the future of Fannie Mae and Freddie Mac, but also to many pending changes to financial-market regulation in the wake of the 2008 crisis and the passage of the Dodd-Frank Act. FHA is a critical market driver and source of taxpayer risk, but it is not the only force redefining U.S. housing finance. To consider it in a "silo" may lead to neglect of other pending policies that – even if FHA reform is speedily enacted in meaningful fashion – still may not fully support a vibrant mortgage-finance system largely reliant not on taxpayers, but rather on private capital.

With specific regard to FHA, I recommend that:

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[1] Since 1985, Federal Financial Analytics, Inc. has provided analytical and proprietary advisory services to private corporations and government agencies in the U. S. and other major financial centers. The firm's practice includes a focus on U. S. residential-mortgage finance, including analysis of legislative, regulatory and policy matters governing issues such as the role of the FHA, the structure of the GSEs, pending efforts to reform asset-backed securities, U. S. and global regulatory-capital regulation and similar matters. The firm has frequently testified before the U. S. Congress on these matters (see WWW.FEDFIN.COM) and has otherwise been honored to participate in the public debate on these vital matters. Federal Financial Analytics, Inc. does not lobby on behalf of any clients.

- Congress should reduce the 100 percent full-faith-and-credit guarantee provided by the FHA to parallel the limited coverage of 25% to 50% successfully used by the Veterans Administration (VA) for the mortgages it has guaranteed for several decades. Reducing coverage levels will effectively cap the severity of loss on FHA loans and improve their underwriting by putting the lender at risk. It is simply impossible for there to be real incentive alignment between mortgage originators and the taxpayer if originators take all the profit and the U. S. taxpayer takes all the risk. Further, expansion of housing programs with the full-faith-and-credit backstop distorts the U. S. financial system and global capital markets because capital regulations and many other requirements strongly favor obligations of this sort over those backed by private capital, creating a high barrier to the re-entry of private capital to U. S. residential-mortgage finance.

- The FHA should be targeted to borrowers based on income, not home price. Currently, high-income low down payment borrowers are often eligible for full-faith-and-credit U.S.-backed mortgages even though the private market for their mortgages would otherwise be deep, liquid and efficient. When the U. S. Government (USG) supports mortgage finance for higher-income borrowers, it supplants private capital otherwise ready to take on this risk and creates market distortions because of the lack of market discipline applicable to these larger loans.

- Current FHA policy should be significantly revised with regard to delegating underwriting to the loan originator and reviewing underwriter performance only after the fact. Instead, FHA should be authorized to share risk with regulated, capitalized providers of private credit –risk enhancement for mortgages (if unaffiliated with the originator). This deep source of private capital would conduct a second underwriting prior to loan origination, applying discipline derived from the incentive alignment between the FHA and private providers of credit-risk mitigation based on shared risk.

- A strict capital requirement should be set for the FHA single-family fund incorporated through a new actuarial model that accurately predicts losses. Additionally, the budgetary treatment of FHA should be changed to reflect the fair value analysis recommended by the Congressional Budget Office (CBO) currently applies to the budget treatment of the GSEs.

Reflecting the above recommendations for FHA in the broader framework of U.S. mortgage-finance regulation and government intervention, I recommend that:

- Congress should work to ensure that an array of pending prudential rules for banks (e.g., those implementing the Basel III capital and liquidity rules) do not so favor USG-backed mortgages as first to block the re-entry of private capital and, second, to prevent constructive reform of Fannie Mae and Freddie Mac. Although many pending rules would exempt the GSEs in conservatorship, treating them essentially the same as FHA, the conservatorships should end as quickly as possible. Once that occurs, if the U.S. financial-market regulatory framework creates only strong incentives for reliance on USG obligations, then mortgage risk will flood into the FHA, putting taxpayers at acute risk even if all of the reforms outlined above are in place.

- A critical pending rule would implement the risk-retention provisions of the Dodd-Frank Act, creating a new "qualified residential mortgage" (QRM) criterion that would exempt loans from costly risk retention. Although down-payment and loan-to-value (LTV) requirements are a key prudential factor, the QRM should not (as proposed) set a simple down-payment requirement without regard to the use of regulated, capitalized providers of credit-risk mitigation like private mortgage insurers. Doing so would make it extremely difficult to securitize high-LTV loans for first-time home-buyers and other borrowers who can prudently manage low down-payment mortgages demonstrated by careful underwriting backed by private capital at risk. If the QRM advances as proposed, these loans will flood into the GSEs and FHA and, once the conservatorships are closed, then only into the FHA.

The Risks Covered by Mortgage Insurance

When providing credit-risk mitigation (CRM) against default by a borrower, insurers face two key risks: first, the probability that a loan will go into default and, second, the severity of loss – that is, the amount the insurer will have to pay based on factors such as house-price depreciation, foreclosure costs and property damage. While much attention has been paid to the probability of default on the loans FHA insures, the severity of default risk to which FHA is exposed with its 100% coverage is at least as important when considering taxpayer risk.

FHA's 100% Guaranty

The FHA complete guaranty of mortgage risk distorts the incentive structure for lender/servicers and puts the taxpayer at unnecessary risk. There are three simple points that demonstrate that 100% FHA insurance coverage is self-defeating for FHA and the U.S. taxpayer:

1. FHA is exposed to severe losses on every loan that goes to claim during a house-price decline such as that experienced since 2006;
2. FHA exposes itself to fraud and poor underwriting that would not otherwise occur if the loan originator had "skin in the game" on every FHA-insured loan it originates; and
3. Reducing the level of insurance coverage on future FHA loans while holding the FHA premium at its current level would recapitalize the FHA MMI fund with positive budget scoring.

As noted by the Department of Housing and Urban Development (HUD) Inspector General, "[a]s a mortgage insurer, FHA pays the ultimate cost of loans that go bad. Lenders are made whole, but FHA seldom recovers that cost in reselling the properties to the public."[2] When the HUD IG made this statement in 2007, he noted that "FHA loses an average of 30% of each insurance claim it pays, when sales costs are netted against the payout to the lender/claimant." [3] By 2008 the loss severity rate for non-HECM FHA-insured loans that went to claim in that year had soared to over 62% and, by 2010, the loss-severity rate had stabilized at 48%. That is, by insuring 100% of the loan amount, FHA is now losing 50% of its insured amount. [4]

There is no market or policy reason why FHA has to expose itself to this level of loss severity on insured loans. Indeed, the experience of the VA-guaranteed mortgage program demonstrates that lowering the level of insurance coverage reduces both the severity of loss and the probability of default.

FHA, VA and Ginnie Mae

The FHA and its government securitizer, the Government National Mortgage Association (Ginnie Mae), provide investors in single-family mortgage backed securities (MBS) with a security that is completely backed by the U.S. taxpayer. Ginnie Mae does not issue MBS, but approves the private lenders who issue MBS for which it provides the

[2] Statement of Kenneth M. Donohue, Inspector General, Department of Housing and Urban Development Before the Senate Committee on Banking, Housing, and Urban Affairs, July 18, 2007.
[3] Ibid.
[4] Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012, November 5, 2012, p. E-3.

backstop guaranty. The issuers advance payments of principal and interest to the MBS investor when a loan underlying the MBS defaults. It is then that the government insurance (primarily FHA and VA) repays the issuers. However, the investor in the Ginnie Mae MBS does not worry about the ability of the issuer to make a payment because Ginnie Mae insures the performance of the issuers and provides the MBS investor with a complete and explicit government guaranty on the timely payment of principal and interest. Private entities cannot provide investors with a similar taxpayer-backed guaranty and consequently Ginnie Mae securities are better priced than even MBS backed by the GSEs.

In the marketplace, this favored position for Ginnie Mae-backed securities should be passed through to the mortgage borrower in the form of the lowest interest rate available given the prepayment risk associated with the mortgages underpinning the MBS. To the extent this is the case, the U.S. taxpayer is providing both the MBS investor and the homeowner utilizing the government-backed mortgage significant benefits at a potential cost to the taxpayer that will be reduced by lowering the FHA coverage level so as to cap potential losses while targeting FHA only to borrowers who cannot achieve sustainable homeownership without government support.

VA Coverage Levels Adequately Support Ginnie Mae

As Ginnie Mae notes in its annual report, it “absorbs losses only after all other mortgage safeguards (homeowner equity, mortgage insurance, and lender resources) are exhausted, thus minimizing risk to the taxpayer."[5] In the case of FHA-insured loans, FHA provides Ginnie Mae with a complete government guarantee in the event the issuer fails in its obligation to make a payment, but the same is not the case for VA-guaranteed mortgages that back Ginnie Mae MBS. The VA guaranty varies from 25% to 50% of the mortgage loan amount with the coverage falling as the loan amount increases.[6] However, from the MBS investor's point of view, the explicit U. S. guarantee of timely payment of principal and interest backed by Ginnie Mae remains the same for the MBS composed of FHA and VA loans. So, when an issuer fails to meet its obligations, Ginnie Mae steps in to provide the MBS investor with the timely payment of principal and interest. Ginnie Mae then acquires control of the issuer's mortgage servicing rights and places the portfolio with a financially-sound master subservicer. As Ginnie Mae notes, "it is through investors' confidence in this sustaining model that Ginnie Mae ensures that capital continues to flow to the Nation's housing finance system." [7]

What is clear, however, is that 100% insurance coverage by FHA is not necessary to facilitate investor confidence in the ability of Ginnie Mae to guarantee the timely payment of principal and interest. Indeed, the much more limited VA guarantee combined with Ginnie Mae's power to acquire an issuer's mortgage servicing rights is a superior structure to the 100% FHA guarantee since it protects the U.S. taxpayer from both a high probability of default and high severity of loss on defaulted mortgages.

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[5] Government National Mortgage Association Annual Report 2012, November 13, 2012 letter from Theodore Tozer to HUD Secretary Shaun Donovan (p.2).

[6] Under 38 USC Sec. 3703 the guaranty amount for a borrower with full entitlement is 50% for loans of $45,000 or less; $22,500 for loans greater than $45,000, but no more than $56,250; the lesser of $36,000 or 40% of the loan amount for loans greater than $56,250, but no more than $144,000 or; 25% of the loan amount for loans of $144,000 to $417,000; or for certain loans in excess of $417,000, the guarantee will be the lesser of:25% of the county loan limit or 25% of the loan.

VA Loans Perform Better Than FHA Loans

Clearly, the limited coverage of VA-guaranteed loans puts the issuer's capital at risk instead of the US taxpayer's in the event the loss severity of a loan exceeds the VA insured amount. However, the fact that the issuer is placed at potential risk on each and every VA-guaranteed loan means that the issuer is inevitably going to perform a thorough underwriting to protect its own capital. This is critical in programs such as VA and FHA, where the underwriting is delegated to the lender/issuer.

The default data for VA and FHA loans validates this point. Data collected by the Mortgage Banker's Association (MBA) show that VA-guaranteed loans have experienced serious delinquencies at a rate that ranges from 50% to 60% of the comparable rate for FHA-insured loans.[8] In fact, since 2009, the serious delinquency rates for VA-guaranteed loans have been lower than the comparable rate for prime loans.[9] The significantly better performance of VA-guaranteed loans as compared to FHA-insured loans has been consistent for years and generally holds regardless of the geographic location of the loan.[10]

Importantly, the better performance of VA-guaranteed loans is not an aberration and cannot be attributed to the size of the program. At the end of FY 2012, VA-guaranteed loans accounted for 32% of all outstanding Ginnie Mae guaranteed

[7] Ginnie Mae 2012 Annual Report, p.7.
[8] See for example The National Delinquency Survey for the Third Quarter of 2012, published by the Mortgage Banker's Association of America, pp.11.
[9] Ibid., p.10.

issuances.[11] With $384 billion of outstanding VA-guaranteed mortgages underpinning Ginnie Mae MBS, the VA program and its default experience has become a major factor in the mortgage market. Indeed, VA-guaranteed mortgage originations in calendar year 2012 totaled $129 billion, equivalent to 53% of the total FHA single family originations.[12]

While other factors might contribute to the better performance of VA loans, limited insurance coverage and the lender's exposure to loss on every loan inevitably means that better underwriting occurs.

Applying Reduced Coverage Levels to FHA

As noted, VA coverage levels fall as the loan amount increases but only range between 50% and 25% of the loan amount, with the average coverage in the 25% to 30% range. Coverage by private MIs varies by initial LTV, with the GSE charter requirements bringing the initial LTV down to below 80%. Currently, this generally means coverage levels of 25% to 30%, although in the past deeper MI coverage to 35% has been required by the GSEs.

In order to facilitate a smooth transition to reduced coverage levels, it is appropriate for FHA to set a single coverage level of 30%, with the only exceptions made for loans in inner-city, low-income areas or other geographic areas where the value of the underlying property is uncertain. For these areas, a coverage level above 30% might be

[10] Ibid.,p.6.
[11] Ginnie Mae 2012 Annual Report, p. 10
[12] See *Inside Mortgage Finance*, February 1, 2013, p.4

appropriate, but it should not exceed the 50% coverage level that applies to lower dollar amount VA-guaranteed loans.

As Ginnie Mae starts to deal in FHA-insured mortgages with less than 100% coverage, it should be given the authority to increase its guarantee fee to the issuer. The guarantee fee has been fixed in law at 6 basis points for decades, but, this may no longer be sufficient to deal with a program where all loans backing a Ginnie Mae security have less than 100 percent insurance coverage. If a higher guarantee fee is needed to compensate Ginnie Mae for any new risk, Ginnie Mae will have to be granted the flexibility to increase its guarantee fee.

Other Reforms to FHA

Reducing the coverage level of FHA-insured loans will be the most positive step that Congress could take to improve the performance of the FHA single-family program. However, below are several other changes that would assure that the taxpayer backstop in FHA is only targeted to qualified borrowers who do not have access to other financing sources.

1. Target the FHA Using Borrower Income and Not House Prices

   The current system of setting FHA eligibility by loan size, not borrower income, contradicts the purpose of government intervention: serving only those whose needs cannot be met by markets when these needs meet agreed-upon policy goals. A government program must focus on the people it serves.

This is best determined by looking at the actual individuals using a program, not at abstract indicators, proxies, or substitute factors. It is time that FHA becomes an income-targeted – rather than a loan amount targeted – housing program. The current system for setting FHA area loan limits raises them above true median house prices, never lowering them even if house prices fall. Indeed, the current FHA nationwide base limit of $271,050 is significantly higher than the national median existing house price of $176,600[13] which means that entire states where house prices are comparatively low now have an FHA loan limit that greatly exceeds the median house price anywhere in the state. Income targeting FHA's single-family program will assure that low- and moderate-income borrowers become the primary focus of the program and not borrowers who can afford large loans even when interest rates increase.

2. Fix the FHA MMI Fund Actuarial Review Process

   The model used by FHA for assessing the actuarial value of its single-family insurance fund is not working. Since 2007, the current model—even with the changes made over the years—has consistently over-estimated the economic value of the MMI Fund and the economic value of each new year's book of business. As the HUD Inspector General noted last year, "FHA continues to project that the current and future year's books of business will be profitable and make up for these past years losses. However, what we have seen in the past three years is a troubling trend whereby the point at which the Fund is

[13] See National Association of Realtors Report on Existing Home Sales, January 22, 2013 available at: http://www.realtor.org/topics/existing-home-sales/data

expected to reach its mandated capital level is pushed farther into the future."[14] Similarly, in 2010, the outside firm hired by the HUD IG to review the independent actuary's report on the MMI Fund concluded that the "design of the current model does not provide an effective way to communicate risks."[15] Finally, the most recent report of the HUD IG on FHA finances noted that as of the end of FY 2012 the capital reserve account of the single family fund had insufficient funds to cover the re-estimate of expected higher losses.[16] Every year, FHA sends to Congress a re-estimate of the performance of its books of business and, every year, the re-estimate has been adverse to the Fund. Clearly, changes have to be made for Congress to receive a correct and timely update as to whether or not FHA will require a taxpayer bailout.

3. Correct the Budget Accounting for the FHA Program

The Congressional Budget Office prepared a report in 2011[17] that noted the differences between the current budget accounting methodology for FHA and fair-value estimate which incorporates a market-based risk premium that recognizes the financial risk that the government assumes when issuing credit guarantees. This fair-value estimate is more costly to U.S. taxpayers but it shows the true cost of government guarantee program. The fair-value approach

[14] Testimony of the Honorable David A. Montoya, Inspector General, U.S. Department of Housing and Urban Development, Before the U.S. House of Representatives Committee on Appropriations, Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, March 29, 2012, p.4.
[15] Independent Auditor's Report to the HUD IG, 2011-FO-0002,Audit of Financial Statements for FY 2010 and FY 2009, dated November 5, 2010attached to letter from HUD IG to David Stevens, FHA Commissioner, Appendix A, p.14.
[16] Independent Auditor's Report to the HUD IG, 2013-FO-0002,Audit of Financial Statements for FY 2012 and FY 2011, dated November 9, 2012 attached to letter from HUD IG to Carol Galante, Acting FHA Commissioner, p.7 (referencing Note 6).

is used by CBO to assess the GSEs and it should be used to assess the operations of FHA. As CBO noted, the application of a fair-value approach to FHA increases the estimated subsidy rate of the single-family program to such a degree that the program would show a cost rather than savings. Importantly, the fact that the GSEs are accounted for under CBO's budget on a fair-value basis, while FHA's is scored under FCRA accounting, distorts incentives to expand the FHA program without recognizing its true cost. As CBO noted, "because costs recorded on a FCRA basis are generally below fair value, if legislation would cause mortgage borrowers who would otherwise obtain a guarantee from Fannie Mae and Freddie Mac to instead use an FHA program on the same terms, the legislation could appear to produce budgetary savings, even though the government's exposure to losses from defaults would be identical."[18]

4. Authorize FHA to Develop a Risk Share Program with Private Providers of CRM for Residential Mortgages

   As a program where the mortgage underwriting is delegated to the lender/issuer, the FHA exposes itself to the risk that poor underwriting will only be found after a loss occurs. It is important that the taxpayer be protected at the front end of loan origination from poor FHA-delegated underwriting. FHA should thus be authorize to engage in risk shares with private providers of credit-risk mitigation for residential mortgages. Eligible CRM providers here should be:

[17] Report from Douglas W. Elmendorf to Congressman Paul Ryan, May 18, 2011, Accounting for FHA's Single Family Mortgage Insurance Program on a Fair Value Basis.

- regulated under either state or federal standards acceptable to HUD as established by rule;
- expressly subject to rules that bar correlation of risk between the CRM provided for FHA and other mortgage-finance activities; and
- unaffiliated with any loan originator making use of FHA.

Eligible private CRM providers would then separately underwrite each insured loan to verify that the lender/issuer is following the jointly agreed upon process of loan underwriting and verification of borrower income, credit, debt service and other key underwriting criteria. By putting the private insurer on the same risk with FHA, the taxpayer will be protected by both its private capital and its private loan underwriting expertise.

Conclusion

At the outset of this statement, I indicated that FHA reform couldn't be viewed in isolation from pending regulatory developments or – even more importantly – the need quickly to determine a course for Fannie Mae and Freddie Mac that brings them out of conservatorship. Together, FHA, Fannie Mae and Freddie Mac now dominate the U.S. residential-mortgage market. Private capital will only be attracted to the mortgage space when and if it becomes clear that market has been reopened through the retreat of the government. Today, a combination of regulatory uncertainty and the crushing impact of

[18] Ibid.,p.6.

a U.S. Government guarantee quash the ability of private capital to invest in the new systems and develop the new products necessary to originate, service and securitize loans to advance credit availability without sowing the seeds of another systemic crisis.

The huge role of the U.S. Government in mortgage finance means that Congress should advance FHA reform in tandem with other changes. For example, putting Fannie Mae and Freddie Mac into a new form that terminates the conservatorship might promote private capital, but not if FHA continues its 100% guarantee at current loan levels without appropriate originator discipline or risk-sharing with appropriate sources of private capital. One-sided GSE reform will only drive still more risk to taxpayers through FHA, an especially dangerous prospect given the many systems and risk-management problems that have brought FHA to the parlous condition revealed in its most recent actuarial report.