U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410

Written Testimony of David H. Stevens
Assistant Secretary for Housing/FHA Commissioner
U.S. Department of Housing and Urban Development

"FHA Capital Reserve Ratio"

Hearing before the Subcommittee on Housing and Community Opportunity
U.S. House Committee on Financial Services
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Chairwoman Waters, Ranking Member Capito, and Members of the Subcommittee, thank you for the opportunity to testify on the Federal Housing Administration's (FHA) Capital Reserve Ratio. As you know, the FHA is playing a critical role in the housing market and our economy right now – insuring a third of the home-purchase mortgage market and 80 percent of its purchase loans are for first-time homebuyers.

But as you also know, FHA recently announced that our independent, non-governmental actuarial review is expected to predict that FHA's capital reserve ratio will fall below two percent. There has been considerable confusion about what this announcement means for FHA's overall fiscal health and whether this means the taxpayer will bear any responsibility going forward.

And so I welcome this opportunity to clarify our situation and discuss the proactive steps being taken to ensure that FHA remains financially sound so that we can continue to support and revive the housing market.

<u>FHA's Two Reserve Accounts and How They Function</u>

Let me simply state at the outset that based on current projections, absent any catastrophic home price decline, FHA will not need to ask Congress and the American taxpayer for extraordinary assistance – we will not need a bailout. FHA holds reserves for the net present value of estimated net losses on its outstanding Mutual Mortgage Insurance Fund (MMI) loan guarantee portfolio in the financing account, and, backed by the full faith and credit of the federal government, will always have funds sufficient to meet projected costs. In combination with the Reserve Receipt Account, FHA's MMI Fund currently holds more than $30 billion in cash reserves.

The capital reserve account is a surplus reserve account that holds cash reserves in excess of the cash reserves held in the financing account, FHA's main reserve account. The financing account is required to hold reserves equal to the present value of net losses projected over the next thirty years. To the extent the reserves exceed the net present value cost of the loan guarantees, excess funds are paid to the capital reserve account. If the present value estimated net losses exceed the reserves, funds are paid from the reserve account to make up the difference. This is somewhat analogous to a checking and savings account, with the financing account holds reserves, pays default claims or other losses, and receives any payments received from the public, while the capital reserve account holds surplus cash.

So, why is the capital reserve ratio predicted to fall below two percent? That's because the capital reserve ratio only measures how much is in the secondary capital reserve account. In light of the severe decline in house prices, overall performance of the economy, and future housing price projections, FHA expects higher net losses than previously estimated on outstanding loan guarantees, over the next thirty years and more than are currently reserved for in the financing account. This change, in combination with stresses accounted for in prior reviews, will drive the ratio below two percent. As a result, surplus funds will be paid from the capital reserve account to the financing account. After this, there will still be additional funds remaining in the capital reserve account, over and above the reserve necessary to meet future expected losses.

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

FHA only insures owner-occupied residences and has never insured exotic subprime, Alt-A, or "no-doc" mortgages. FHA has also never wavered from requiring full documentation of employment and income when underwriting new home purchases. This responsible approach has allowed us to limit losses during this economic crisis and fulfill our mission of providing safe opportunities for homeownership to those who can afford a home.

Bringing FHA into the 21st Century

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

We have made more significant credit policy changes in the past few months than FHA has in decades.

We've brought on new leadership with broader and deeper knowledge and skills and a tighter set of risk controls for the agency, recently hiring a new Deputy Assistant Secretary for Single

Family Housing. And we are in the process of hiring a Chief Risk Officer to oversee a single division we want devoted solely to managing and mitigating risk to the insurance fund.

And with Congress's help, we are working to modernize our information technology systems, so that we can develop a set of commonly-used fraud detection tools and a fully-automated underwriting system that helps us focus our attention on the loan files that are most likely to contain serious deficiencies and I look forward to discussing more on each of these topics in detail later in the testimony.

FHA's Operations and Role in the Housing Market

The Federal Housing Administration provides mortgage insurance on loans made by FHA-approved private lenders. FHA does not lend directly to the consumer or issue debt to fund its operations. As such, FHA does not resemble private financial institutions, including mortgage lenders or investment banks like Countrywide Financial or Bear Stearns, to which FHA has been compared inaccurately by those who do not understand FHA's business model. FHA does not have a leverage ratio as it does not hold debt on its balance sheet. FHA is financed from mortgage insurance premiums paid to FHA in exchange for providing mortgage insurance. FHA holds reserves in its financing and capital reserve accounts. Balances in these accounts represent the net sum of premiums collected from borrowers minus any insurance claims that FHA pays to lenders, e.g., in the event that a homeowner defaults on their FHA-insured loan. FHA only insures those loans that meet FHA's underwriting criteria, as described earlier. By providing mortgage insurance to lenders on these loans, FHA provides protection to lenders against the risk of default, which expands liquidity in the market and has enabled homeownership opportunities to be expanded to a broader population.

Countercyclical Role of FHA and Private Mortgage Insurance

The private financial institutions to which FHA is most similar are private mortgage insurers (PMIs) who also offer mortgage insurance to private lenders to protect them from the risk of default by a borrower. FHA has recently experienced significant swings in its market share as FHA largely plays a countercyclical role to ensure critical liquidity remains in the mortgage market when private mortgage insurers decide to or are forced to insure fewer loans. Much attention has been paid to recent statistics showing that FHA is currently insuring more than 25% of new home mortgages, a significant increase from approximately 3% in 2006.[1] This increased market share is largely the result of market pullback by PMIs from providing new mortgage insurance as they are capital-constrained from paying claims and reserving funds for large expected losses on their historical portfolio. FHA is partially filling the void left by PMIs and is

[1] Inside Mortgage Finance

playing its historical role of enabling home purchases for individuals who can afford homeownership but do not have access to private mortgage insurance. FHA has not loosened its underwriting standards and in fact has experienced a significant improvement in credit quality of newly insured borrowers, from an average FICO score of 633 two years ago to 693 today.

Most lenders require mortgage insurance from homebuyers who obtain loans that are more than 80 percent of their new home's value, either in the form of FHA insurance or from PMIs. Unlike FHA, however, PMIs have been willing to offer a wider variety of insurance coverage options on a wider variety of mortgage products. At the peak of the housing boom, this flexibility led PMIs to offer insurance coverage on products such as subprime and option-ARM loans which enabled homebuyers to obtain mortgage insurance at a lower initial cost than a traditional fixed-rate FHA-insured loan. This led to a sharp decline in FHA's market share of home mortgages to approximately 3% in 2006 from its more traditional share of between 10-15% in the 1990s.[2] This dramatic reduction in market share also further limited FHA's exposure to problem loans as it saw its market share decline significantly in many states that have since experienced the sharpest price declines. Many of these problem loans insured by PMIs proved to be unsustainable to the borrower over the long-term and PMIs have since been subject to substantially higher default claims than FHA as borrowers can no longer afford these subprime and other types of exotic loans. For example, as of August 2009, FHA's seriously delinquent rate was 8.37 percent. The overall seriously delinquent rate for Alt-A mortgages is 21 percent as of July 2009 and the seriously delinquent rate for negative amortization Alt-A mortgages is 33 percent.

A report released by the Federal Reserve last Wednesday, October 1, 2009 states:

> Beginning in the early part of 2008, PMI companies started limiting their issuance of PMI insurance and raising prices because of rising claims and binding capital restrictions in certain states. As a consequence, Fannie Mae and Freddie Mac substantially reduced their purchases of loans with loan-to-value ratios (LTV) above 80 percent, which by statute require PMI (or other credit enhancement). Both GSEs [Fannie Mae and Freddie Mac] also raised their credit guarantee fees for such loans at this time as well.[3]

These actions taken by PMIs and GSEs in reaction to losses on their historical portfolios have led to FHA-insured loans becoming relatively cheaper and more accessible to borrowers, compared

[2] FHA Share of Home Purchase Activity; Sources: FHA Office of Evaluation, National Association of Realtors, U.S. Census Bureau

[3] "The 2008 HMDA Data: The Mortgage Market during a Turbulent Year," draft report published October 1, 2009 in the *Federal Reserve Bulletin*

to PMI-insured loans than they were during the boom. FHA's increased market share is a result of this countercyclical market dynamic and not in itself a reflection of the riskiness or lack thereof of newly insured loans.

Historically, FHA has played this countercyclical role more than once before. FHA was created in 1934 to fill a market void in which few individuals had access to homeownership due to typical mortgage loan terms requiring 50% downpayment and three to five year repayment schedules. FHA insurance enabled lenders to offer more affordable loan terms that led America to transition from a nation primarily of renters to one of the highest homeownership rates in the world. In the 1980s, FHA moved in to steady falling home prices and made it possible for potential homebuyers to get the financing they needed when recession prompted private mortgage insurers to pull out of oil-producing states. FHA's role has evolved over the past 75 years to continue to serve as a countercyclical stabilizing force in the market and also to ensure that underserved populations have access to homeownership opportunities.

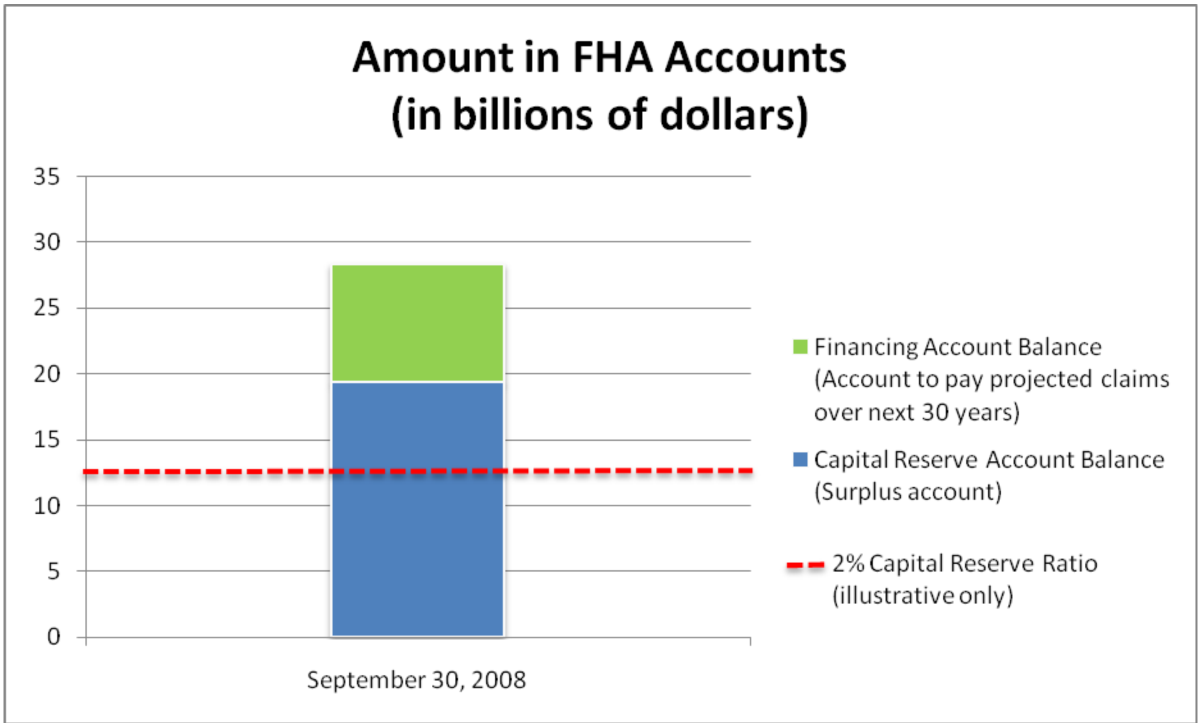
In fiscal year 2008, FHA insured over 1.1 million single-family loans – almost triple what was insured the year before. In fiscal year 2009, FHA insured approximately 2 million loans. FHA anticipates that it will continue to insure a significant volume of mortgages in fiscal year 2010 as it continues to play an important role in the housing market.

Today, FHA is critical to the recovery of the housing market for both existing and new homeowners. FHA's single-family purchase-loan portfolio is currently 80 percent first-time homebuyers, of which 27 percent are minorities. FHA provides opportunities for first-time homebuyers who have good credit histories but may not have a large downpayment to purchase homes, which has a stabilizing effect on home values. Equally as important, over 49 percent of the loans insured by FHA in fiscal year 2009 have been refinances, thereby helping existing homeowners to move into safe, fixed-rate loans, with historically low interest rates. These refinances have, on average, saved homeowners between $100 - $200 per month on their housing expenses.

Additional Information about the Capital Reserve Ratio

New upfront mortgage insurance premiums paid at loan closing and ongoing premiums paid over the life of the loan are deposited in the financing account. Based on an annual review of economic conditions and projections, the cost of outstanding loan guarantees are reevaluated, and the amount of reserves held in the financing account are adjusted to ensure that there are sufficient resources in the financing account to cover the net present value of estimated costs of outstanding guarantees, and any surplus reserves are held in the capital reserve account. At the end of fiscal year 2008, the independent audit led to the financing account holding $9 billion in reserves and obligated balances, and the capital reserve account held $19.3 billion in excess reserves, for a total combined reserve balance of $28.3 billion. The capital reserve ratio only refers to the funds held in the capital reserve account. As such, the fiscal year 2008 capital ratio was 3% on a total insurance in force of $439.6 billion. This is illustrated below in Figure 1.

Figure 1. Fiscal Year 2008 Combined FHA Reserve Accounts



FHA is currently awaiting the final results of its independent actuarial review for Fiscal Year 2009. Preliminary results have indicated that additional funds will need to be transferred from the capital reserve account to the financing account. This transfer is necessitated by an increase in projected future losses on outstanding loan guarantees. This requires FHA to hold more funds in its financing account to cover expected future losses. The primary reason for this increase in dedicated loss reserves is a new home price forecast produced by IHS Global Insight, which is one component used by the actuarial firm to project future losses, which shows the bottom of the market delayed from 2009 to 2010, and reflects an additional 8.4 percent price decline in the US Single Family housing market. It is important to note that in their September forecast, Global Insight has moderated their forecast to a 7.7 percent decline before prices stabilize, and they, as well as other market data sources have indicated that prices may have already stabilized in many parts of the country. The change in housing price forecasts between 2008 and 2009 is depicted in Figure 2 below.

Figure 2. IHS Global Insight August 2009 Revised Housing Price Index Forecast

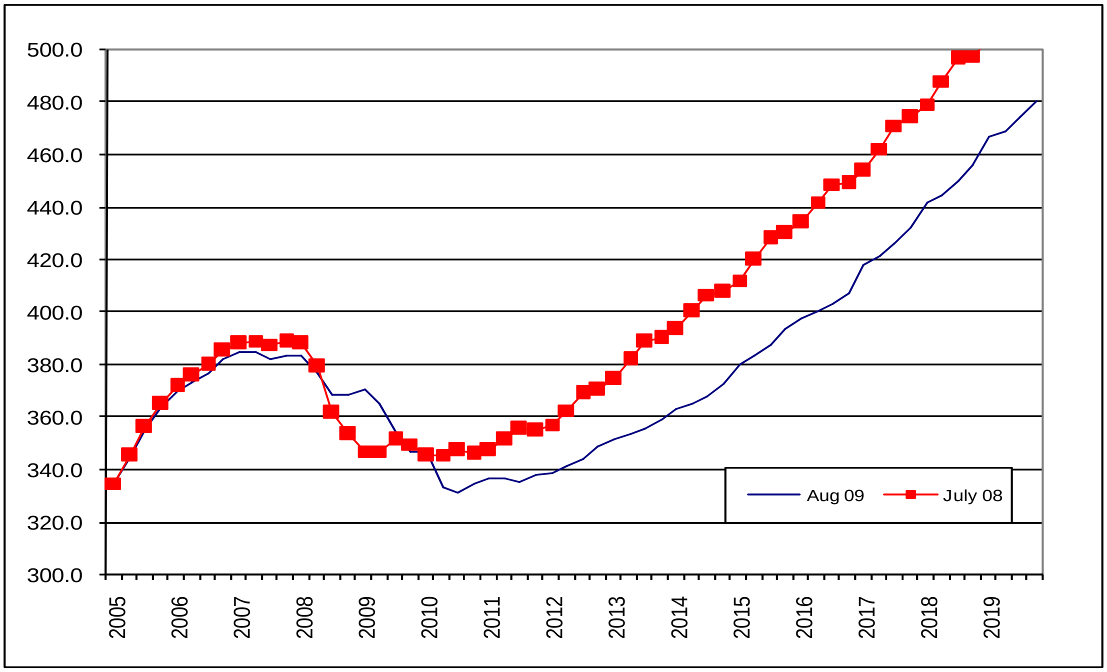
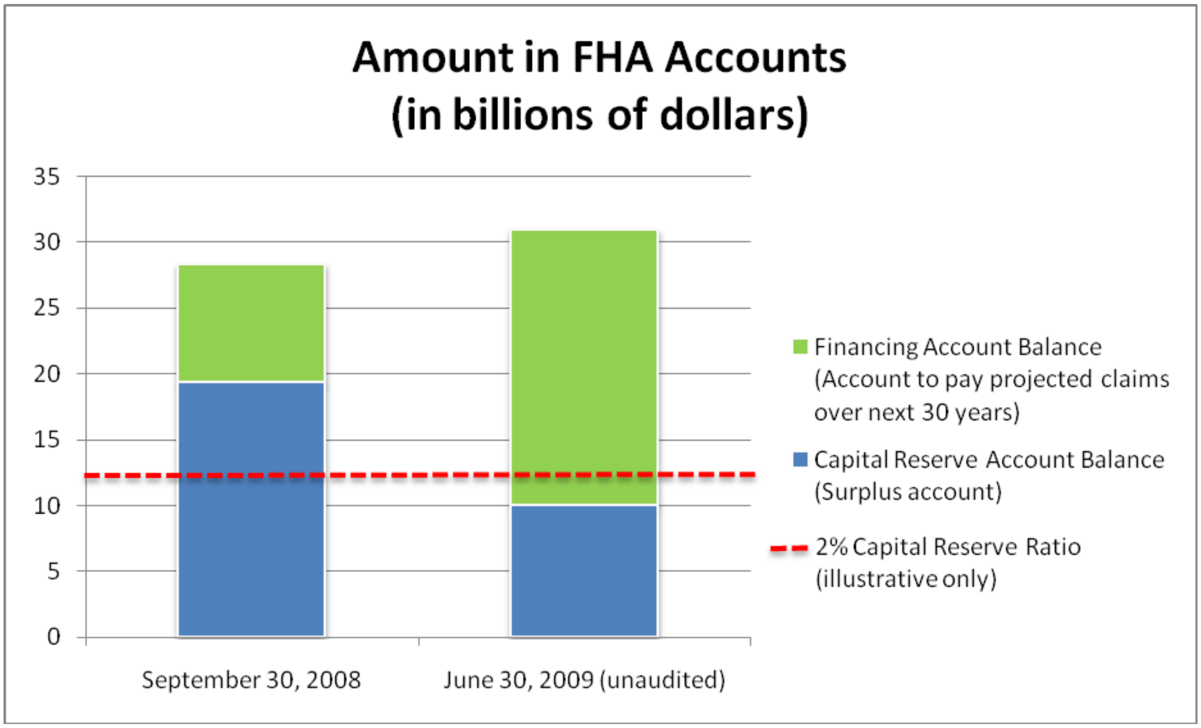


Figure 3 portrays the flow of funds from the capital reserve to the financing account and is an illustration of how FHA adjusts its funds to reflect projections of expected future losses. The most recent period for which FHA has financial results is June 30, 2009 (unaudited). The total reserve balance has increased because of a surplus in total premium revenue over net insurance claim expenses over the nine month period. The shifting of funds from the capital reserve account to the financing account was done as a result of the FY 2008 actuarial review, which indicated that additional funds should be transferred to the financing account to cover future expected losses.

Figure 3. Change in Combined FHA Reserve Accounts as of June 30, 3009



The new FY 2009 actuarial review is expected to indicate that FHA will again need to increase its loan loss reserves in the financing account because of house price assumptions and other economic variables that suggest an increase in cost on the outstanding portfolio. This will necessitate an additional transfer of funds from the capital reserve account to the financing account. Based on the preliminary results, the capital reserve ratio is expected to drop below the two percent threshold. The reestimated cost of the portfolio (and actual amount of the capital reserve that will be paid to the financing account) will be reevaluated, and reflected in the 2011 Budget. If the portfolio ultimately performs better than current forecasts suggest, there will be a downward reestimate, and the excess funds returned to the capital reserve. Over the life of the outstanding loan guarantees, it is very likely that the projections will be revised – in either direction. Should future projections indicate that FHA will experience fewer losses in the future, funds may be shifted from back into the capital reserve account. The drop in the capital reserve ratio below two percent is anticipated to be for a relatively short period of time and the ratio is expected to return above two percent within the next two to three years, on its own, even if FHA were to make no policy changes at all. The current drop in the capital ratio in no way indicates that FHA is at risk of needing an immediate capital infusion as it currently holds more than $30 billion in total reserves. To the extent that FHA's newly insured MMI loans are expected to earn revenues in excess of expected losses on a present value basis further strengthens its capital position as new mortgage insurance premiums will continue to add to FHA's reserves. While

FHA's capital reserve ratio has dropped below two percent, this is again a limited measure, and does not necessary indiciate FHA's overall financial health.

Newly Insured Loans and Future Books of Business

- The drop in the capital reserve ratio reflects FHA's current position after experiencing the depths of the recession and a historic decline in housing values. As newly insured loans are being underwritten at or close to the bottom of housing prices, there is potentially lower risk that housing values of these new loans will become underwater in the future.
- Recent dynamics in the purchase market have improved the financial health of FHA. Due to the pullback by PMIs, the average credit quality of FHA borrowers had improved significantly in the last two years. The average FICO score for all existing FHA borrowers is 693, compared to 633 two years ago. Two years ago, nearly half of all FHA purchase borrowers had a FICO less than 620; today that number is only 7.5 percent.

FHA is Taking Proactive Measures to Ensure its Fiscal Health

FHA is taking proactive steps with newly-introduced and future credit policy changes, and looking to current and future books of business as a means to increase the capital reserve account and restore the resulting capital reserve ratio back over two percent as soon as possible.

FHA has extensively upgraded its focus on and capabilities for prudent risk management. On September 18, 2009, FHA announced that it will be appointing a Chief Risk Officer, for the first time in FHA's history. FHA's current risk management functions are dispersed across a number of divisions. The Chief Risk Officer will oversee the coordination of FHA's risk management efforts in a single division devoted solely to managing and mitigating risk to FHA's insurance fund – across all of its programs.

Additionally, FHA has recently appointed a new Deputy Assistant Secretary for Single Family Housing. Vicki Bott joined FHA on October 5, 2009 to take on this role and brings over 20 years of experience in the mortgage industry including senior positions at Wells Fargo and other large institutional lenders. Ms. Bott provides additional leadership focused on ensuring the fiscal health of FHA and devoted to enabling FHA to continue providing a critical role in the recovery of the housing market and broader economy.

Finally, FHA announced a series of credit policy changes on September 18, 2009 that are a first step to strengthen FHA's risk management and to ensure responsible lending. These changes are listed below and are described in detail in the attached appendix.

Credit Policy Changes

Changes Effective January 1, 2010 via Mortgagee Letter

- Require Submission of Audited Financial Statements by Supervised Mortgagees.
- Modify Procedures for Streamline Refinance Transactions
- Require Appraiser Independence In Loan Originations
- Modify Appraisal Validity Period
- Appraisal Portability

Changes Being Pursued by Rule Making Process and Currently Under Notice and Comment

- Modify Mortgagee Approval and Participation in FHA Loan Origination
- Increase Net-Worth Requirements for Mortgagees

Conclusion

And so, even as FHA is once again playing a critical countercyclical role in our economy—as it did during the Great Depression and during the Oil Patch crisis of the 1980's, stepping up to ensure housing markets function where the private sector cannot on its own—we are taking nothing for granted.

FHA is working aggressively to not only make sure that our reserves reach congressionally-mandated levels over projected future losses – to make sure we keep affordable, responsible loans flowing, our housing market viable, and our economy on the road to recovery.

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

Appendix – Description of Recent FHA Credit Policy Changes

Changes Effective January 1, 2010 via Mortgagee Letter

- Require Submission of Audited Financial Statements by Supervised Mortgagees.
  Supervised mortgagees will be required to submit audited annual financial statements to FHA. This new requirement is a prudent safeguard that permits FHA to make sure that those entities with which it does business are adequately capitalized to meet potential needs. FHA is aware that the majority of supervised and non-supervised mortgagees are already required to prepare audited financial statements for various regulatory bodies, Government Sponsored Enterprises (GSEs), and investors. Given these existing requirements, FHA's new policy will help to reduce risk at limited new costs for approved mortgagees.

- Modify Procedures for Streamline Refinance Transactions
  Current procedures are revised for streamline refinance transactions to establish new requirements for seasoning, payment history, income verification, and demonstration of net tangible benefit to the borrower; provide for collection of credit score information when available; and to cap maximum CLTV at 125 percent. An appraisal will be required in all cases where a borrower wants to add closing costs to the transaction. These revisions bring documentation standards for streamline refinance transactions in line with other FHA loan origination guidelines, make sure that the borrower is capable of repaying the new mortgage, and prohibit the dangerous practice of loan churning, where borrowers raise cash through successive cash-out refinancings that put them further in debt.

- Require Appraiser Independence In Loan Originations
  New guidelines provided on ordering appraisals for FHA-insured mortgages and reaffirms existing policy on FHA requirements regarding appraiser independence and geographic competence. Mortgage brokers and commission based lender staff are prohibited from ordering appraisals. FHA does not require the use of Appraisal Management Companies or other third party providers, but does require that lenders take responsibility to assure appraiser independence. While FHA's existing policies regarding appraiser independence are consistent with the Home Valuation Code of Conduct (HVCC), FHA will adopt language from the Code to ensure full alignment of FHA and GSE standards.

- Modify Appraisal Validity Period
  FHA's appraisal validity period will be reduced to four months for all properties including existing, proposed and new construction. Previous validity periods were six months for existing properties and up to twelve months for proposed and under construction properties. This provides for more accurate home values used for underwriting FHA-insured mortgages during volatile housing market conditions.

- Appraisal Portability
  New guidelines that allow a second appraisal to be ordered under a limited set of circumstances when a borrower switches from one lender to another and restates the requirement that the first lender must transfer the appraisal to the second lender at the request of the borrower. This will prevent delays in closing that often occur when a loan is transferred to a new lender.

Changes Being Pursued by Rule Making Process and Currently Under Notice and Comment

- Modify Mortgagee Approval and Participation in FHA Loan Origination
  Lenders seeking approval to originate, underwrite, or service an FHA loan must meet the eligibility criteria for a supervised or non-supervised mortgagee. Mortgagees with this approval status must assume liability for all the loans they originate and/or underwrite. Loan Correspondents (mortgage brokers) will continue to be able to originate FHA-insured loans through their relationships with approved mortgagees; however they will no longer receive independent FHA approval for origination eligibility. These policy changes will require the FHA approved mortgagee to assume responsibility and liability for the FHA insured loan underwritten and closed by the approved mortgagee. These changes align FHA with the GSEs and will potentially increase the number of loan correspondents (mortgage brokers) who are eligible to originate FHA-insured loans while providing for more effective oversight of loan correspondents through the FHA approved mortgagees.

- Increase Net-Worth Requirements for Mortgagees
  FHA plans to propose to increase the net worth requirement for approved mortgagees to meet industry standards. The requirement is currently at $250,000 and has not been increased since 1993. HUD is proposing an initial increase of approximately $1,000,000 that would be in place within one year of the enactment of this rule. To maintain consistency with industry standards, HUD may propose that the net worth requirements be increased further in future years to a level comparable to those required by GSEs and other market institutions. These changes will help to ensure that FHA lenders are sufficiently capitalized to meet potential needs, thereby permitting HUD to mitigate losses and decrease risks to the FHA insurance fund.