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Committee on Financial Services
Subcommittee on Insurance, Housing and Community Opportunity
on
"Future Role of FHA, RHS and GNMA in the Single and Multifamily Mortgage Markets"

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Chairwoman Biggert, Ranking Member Gutierrez, and Members of the Subcommittee, thank you for the opportunity to testify on the future role of the FHA program. I am Brian Chappelle of Potomac Partners LLC, a Washington–based consulting firm specializing in mortgage finance.

In my testimony, I would like to address the following areas:

- The mortgage market today and FHA's role
- The effectiveness and current financial condition of FHA & Ginnie Mae
- Reforms proposed in the Discussion Draft
- Other legislative and regulatory suggestions to improve the program

I. Mortgage Market Today and FHA's Role

The state of the housing market is described in the minutes of the latest Federal Reserve's Federal Open Market Committee (FOMC) meeting of April 26-27, 2011 as follows: "activity in the housing market remained very weak" and "demand for housing … continued to be depressed" even though the economic "recovery was continuing at a moderate pace".

In his semiannual monetary policy testimony earlier this year, Federal Reserve Board Chairman Bernanke noted "many potential homebuyers are still finding mortgages difficult to obtain".

Recent FHA, Fannie Mae and Freddie Mac purchase activity confirm the Federal Reserve's observations. In 2010, the three agencies financed less than 2 million purchase loans. That is 9% fewer than they collectively backed in 2009 and more than 30% below the pre-bubble year of 2000. And it appears to be getting worse --- FHA purchase volume has declined 33% in the first seven months of FY 2011.

The good news is that the borrowers being approved today have the highest credit quality in many decades, as the remarkably low early-default rates demonstrate. You can reasonably conclude that the fundamental housing problem today does not stem from the approval of homebuyers with poor credit characteristics, but rather, from the inability of many credit worthy borrowers to obtain mortgages, thereby discouraging potential homebuyers and putting downward pressure on house prices.

As the Subcommittee considers these complex issues, the immediate concern is not about which sector of the market (private or public) is supporting the housing market, but that combined, the public and private sectors are originating a totally inadequate number of purchase mortgages.

Moreover, FHA has already taken significant steps to facilitate the recovery of the private sector by raising its insurance premiums four times in the last three years. The premium is now about 60% higher than it was in May 2008. The increased premium, coupled with the improved performance of the FHA portfolio, should enable FHA to reach the all-important 2% capital ratio much sooner than the auditors projected in the FY 2010 actuarial review.

II. Current Effectiveness and Financial Condition of FHA & Ginnie Mae

Current Effectiveness of the FHA Program

Over the years, two principal objectives have evolved for the FHA single Family program. They are: 1) to serve homebuyers who are not adequately served by the private sector and 2) to operate at no expense to the American taxpayer.

A. FHA's Mission

After the collapse of the housing market in mid-2007, the FHA stepped-in and, to the surprise of some, performed its historic role of counter-cyclicality in a manner that would have made its founders proud. FHA was, in effect, the last entity standing and became the primary financing source for home purchasers. While FHA has helped millions of families from all walks of life to finance their home purchases and refinances, it has continued to fulfill its social purpose according to the Federal Reserve's study on the 2009 data submitted pursuant to the Home Mortgage Disclosure Act (HMDA). The Federal Reserve found that:

- 65% of low and moderate income homebuyers obtained government loans; only 15% chose government loans in 2006. (75-80% of government loans are FHA)
- 48% of homebuyers in distressed areas obtained government loans; only 6% did in 2006.
- Approximately 75% of African American/ Hispanic homebuyers obtained government loans in 2009; only about 20% did in 2006.

FHA's own data for 2010 and 2011 continues to support the Fed's analysis. Approximately 75% of FHA purchase mortgages were for first-time homebuyers and about 30% of FHA purchase loans were for minority homebuyers.

B. FHA's Financial Responsibility

The second principle, which has become even more critical because of the government's challenging fiscal environment, cannot be compromised: FHA must operate at no expense to the American taxpayer as it has for its entire history. Like any successful insurance program, the homebuyers who benefit from the program (in effect policyholders) pay the premiums to cover the costs of insurance. FHA's founders realized this when they charged a high insurance premium (1% annual premium) to ensure that FHA was well-capitalized just like FHA management does today.

(It should be noted that the annual premium was lowered to .5% in 1939 and stayed at that level until 1983 when the Congress enacted the upfront premium of 3.8%, which was the equivalent of the .5% annual premium. In 1990, Congress enacted reform legislation that permitted HUD to charge both an upfront and annual premium. The program also had a mutuality feature until about 20 years ago, which provided distributive share payments (or refunds) to FHA borrowers if their book of loans performed well.)

FHA & Ginnie Mae's Current Financial Condition

Analysis of FHA's and Ginnie Mae's financial performance includes a review of their operational structure and core responsibilities. Ginnie Mae is discussed separately at the end of this section.

FHA's Operational Structure & Responsibilities

In evaluating FHA's financial condition, it is first appropriate to review FHA's operational process since, in 2007, many were also doubting FHA's ability to process the impending flood of loan activity in addition to being concerned about the potential costs to the taxpayer.

There are two principal reasons for FHA's success in handling the spike in the volume without any serious processing delays and at no expense to the taxpayer. First, in 1983, FHA delegated all processing and underwriting functions to approved lenders. Under this program, called Direct Endorsement, FHA authorized approved lenders to originate and close loans without prior HUD review. FHA's functions are concentrated on loan review, oversight and enforcement. With the Subcommittee's support, FHA has improved the tools to carry out these duties.

While it is discussed in greater detail at the end of this section, FHA lenders have significant motivation to operate in a responsible manner in the FHA program. Probably the best example is that, even though an FHA loan is 100% government guaranteed, FHA lenders, starting in early 2008, began imposing their own underwriting restrictions (called credit overlays) on top of FHA underwriting requirements. These overlays have certainly contributed to the over-all quality of the FHA portfolio.

Much has been made of FHA's "antiquated" technology and the need for a complete overhaul of HUD's systems. While some of FHA's systems are old, they are reliable and robust. Even though FHA activity has quintupled from early 2007, our firm is unaware of serious glitches of any kind in the single-family processing system (called FHA Connection) and we interact with FHA lenders on a daily basis.

Taken together, the delegation of processing and underwriting to approved lenders and a reliable automated system enabled FHA to support the housing market immediately after the collapse of the mortgage market.

FHA's Current Financial Condition

In analyzing FHA's financial health, there are four key components that should be considered. They are:

1. FHA's actuarial status: The actuarial review reflects the independent auditor's projection of FHA's ability to pay claims over the entire life of the portfolio (30 years).
2. FHA's cash flow position: FHA's ability to pay claims over the next several years.
3. FHA's credit characteristics: Credit characteristics (particularly credit scores) of the portfolio and new originations, in particular, are important indicators of future performance.
4. FHA's loan performance: The serious delinquency rates of the portfolio and recent originations are critical measures of the program's current operations.

FHA's performance improved in 2010 and has continued to improve in 2011. Just last week, MBA's National Delinquency Survey reported that FHA was the only product type to see its total delinquency rate fall in the 2011 1st Quarter and, in fact, FHA's total delinquency rate is now at the lowest level in more than 5 years.

FHA's net worth is growing faster than expected

At an April 7th Senate Appropriations hearing on the Federal Housing Administration Secretary Donovan said:

> "We expect FHA to make substantially more money for the taxpayer this year than our actuary predicted"

Since FHA's independent actuary projected that FHA's FY 2011 economic value (after paying all expected claims and expenses) would be $10.9 billion, this means FHA's net worth is expected to double in FY 2011. The Secretary added, "Early payment defaults have declined substantially" and FHA has "substantially improved the quality of loans that we are making."

The Secretary did point out that FHA still faces risk from factors beyond its control, namely the impact of additional declines in house prices. He also noted that FHA and its independent auditors have used conservative house price forecasts in their analysis.

The latest public data on the key performance criteria for FHA's basic single-family ("forward mortgage") program are compiled below. (The Home Equity Conversion Mortgage (HECM) program is excluded.) The highlights are:

- FHA's economic value (net worth) and capital ratio are increasing
  - Secretary Donovan said FHA's economic value is on pace to exceed the auditors' projection for FY 2011, which is $10.9 billion (almost $13 billion if the $1.75 billion transfer to HECM account is included).
  - FHA's capital ratio increased from .42 percent to .79 percent in FY 2010 and should be over 1% (1.25% including HECM transfer) in the FY 2011 audit (assuming the house price forecast remains the same).
- FHA's cash reserves to pay claims is growing
  - Even in a Depression scenario, FHA's auditors believe that FHA would have almost $10 billion in cash reserves remaining after paying all claims.
- FHA's serious delinquency rate for its portfolio is declining
  - Through March 2011, the serious delinquency rate has declined to 8.3%. It was 9.1% in March 2010.
  - "This improved loan performance is due to the stronger 2009-2011 books". (HUD Quarterly Report to Congress on MMI Fund (FY2011 Q1))
- FHA's recent originations (loans originated in 2009 & 2010) now have historically low rates of serious delinquency. (HUD Quarterly Report)
  - The early period delinquency rate has fallen 85% since 2007. (Early period delinquency includes loans that experienced a 90-day delinquency within the first six required payments.

- FHA’s current credit quality is the “highest quality on record”
    - Credit scores above 680 account for 60% of FY 2011 originations; 19% for 2007 originations
    - Credit scores below 620 account for 3% of FY 2011 originations; 45% for 2007 originations (HUD Quarterly Report)

Below are expanded details on FHA’s financial and loan performance. (All data obtained from FHA publications.)

The key points are:

- **FHA’s finances continue to improve**

    - FHA’s economic value is growing faster than expected

        - Secretary Donovan said FHA’s FY 2011 economic value (net worth) is on pace to exceed the auditors’ projection of $10.9 billion, which would be almost $13 billion if the $1.7 billion payment to bolster the HECM program was included.
        - FHA’s FY 2010 independent auditor determined that the economic value (capital) of the fund nearly doubled from $2.9 billion in FY 2009 to $5.16 billion in FY 2010 (FHA’s FY 2010 capital would have been over $7 billion if the HECM payment was included).
            - Seller funded downpayment assistance (SFDPA) loans are expected to have a “net cost of $13.6 billion” according to the auditors.
            - The fund would be above the 2% capital ratio today if SFDPA loans are excluded.
        - In addition, while FHA’s foreclosure inventory is at 176,000 properties (“an historic high”), these loans and costs are fully accounted for in FHA’s actuarial review (and economic value).
        - FY 2011 book is now projected to perform even better
            - In his April 7th testimony, Secretary Donovan also testified that the FY 2011 book (by itself) is projected to generate almost $10 billion in net income; <u>$4 billion more than was anticipated</u>.

        - What economic value means:
            - After paying all anticipated claims and administrative expenses over the next 30 years, the auditors projected that, as of the end of FY 2010, the FHA single family “forward” program will not require any additional funds

and will provide the U.S. Treasury over $7 billion in "profit" (projected to be almost $13 billion in the FY 2011 audit excluding the HECM program).

- FHA's all-important capital ratio is also increasing
  - FHA's capital ratio (for single-family forward portfolio) increased from .42 percent to .79 percent in FY 2010 and should be over 1% (1.25% if HECM transfer is included) in the FY 2011 audit (assuming the house price forecast remains the same).
  - Secretary Donovan indicated that FHA should reach the 2% level sooner than FY 2015.

- The new credit subsidy rate for FY 2011 originations has improved to – 2.58 %. (HUD Quarterly Report to Congress)
  - The credit subsidy rate was -1.13% for originations in the second half of FY 2010.
    - In the federal budget, a negative rate means, "the present value of premium revenues is expected to be greater than the present value of net claim expenses".
  - FHA is "now putting more money in its capital reserve account" because of better loan characteristics and higher premiums (2.58% of every dollar insured)

- FHA capital reserves (cash & Treasury securities) are also increasing
  - At the end of FY 2010, FHA's capital reserves increased to over $33 billion on hand.
    - In his April 7th testimony, Secretary Donovan said: "total reserves … were at an historical high of more than $31 billion" in FY 2009 and "grew again" in FY 2010.
  - Even in a Depression scenario, FHA would have almost $10 billion remaining after paying all claims.
  - "FHA's core insurance operations outperformed last year's actuarial projections (FY 2009) by $5.5 billion." (Financial Status of the FHA Mutual Mortgage Insurance Fund)
  - FHA's new premium structure (lowering upfront premium and increasing annual premium) is expected to provide more total revenue over the life of the loan. However, it does create a temporary cash flow imbalance, but it should not last more than a year. (HUD's Quarterly Report to Congress).

        - After a slight decline in FY 2011 (as a result of the MIP change), FHA's cash reserves are expected to grow to $42 billion over the next five years.

- **FHA's portfolio serious delinquency rate is improving**

  In addition to the positive results in MBA's latest National Delinquency Survey, below is the latest FHA data on the performance of the portfolio.

    - The serious delinquency rate (90+ days delinquent, cases in foreclosure, etc.) declined from 9.44% in December 2009 to 8.78% in December 2010.
        - 2007 & 2008 books, which are the worst performing, "now represent just 15% of the active portfolio, compared to close to 19% one year ago"
    - The serious delinquency rate has continued to decline in 2011.
        - Through March 2011, the serious delinquency rate had declined to 8.3%. It was 9.1% in March 2010.
    - As FHA seller funded downpayment assistance loans (SFDPA) work themselves out of the portfolio, performance should improve further.
        - SFDPA share of portfolio was 17% in FY 2010 and should fall below 15% in FY 2011.

- **FHA's recent originations (2009 & 2010) are performing extremely well.**

    - As the Secretary said, "early payment defaults have improved substantially"
    - Only 13% of FHA's seriously delinquent loans are now less than two years old. In December 2009, 30% of seriously delinquent loans were less than two years old. (Neighborhood Watch & FHA Outlook Reports)
    - HUD's Quarterly Report to Congress states:
        - "Early indications are that the FY 2010 book should perform substantially better than the FY 2009 book, which itself performed substantially better than the FY 2007 and 2008 books."
        - "The quality of newly originated FHA loans continues to improve each quarter, … with the early-period delinquency rates of new loans falling to a historic low of .37 percent".

    Below is a chart of FHA's early period delinquency rates (serious delinquency "within first six required mortgage payments") for 2007 - 2010. (The second quarter of each year was chosen to exemplify the improvement because April-June 2010 is the latest quarter available and the rate has declined for every quarter since April-June 2007.)

Early Period Delinquency Rate
All FHA Loans

Origination Quarter	Early Period Delinquency Rate
2007 (April – June)	2.54%
2008 (April – June)	2.08%
2009 (April – June)	1.01%
2010 (April – June)	.37%

The early period delinquency rate has fallen 85% from 2007 to 2010.

- FHA's Neighborhood Watch database provides more insight on the number of performing and seriously delinquent loans.

    - The seriously delinquent rate for loans originated in the last two years fell from 5.05% in December 2009 to 2.83% in December 2010. The December 2010 rate is the lowest level in more than 5 years.
    - The seriously delinquent numbers have continued to improve in 2011. The seriously delinquent rate has fallen to 2.26% in March 2011, which is approaching the lowest rates ever for loans originated in any two-year period since Neighborhood Watch was implemented in 1999.
    - The data for the two-year period ending April 30, 2011 was just published and the seriously delinquent rate has fallen to 2.1%, which appears to be the lowest rate in the 12 years that Neighborhood Watch has been operating.

- Below is a chart from FHA's Neighborhood Watch database that compares seriously delinquent rates for originations for two-year periods by quarter since 2008.

- All Lenders/Areas - Area Totals
  United States Totals
- Delinquent Choice - Seriously Delinquent
  Performance Period - All Quarter End Dates
  Loan Portfolio: 2 Year FHA
- Sort Order by Quarter End Dates in Descending Order
- Data shown includes all quarter end dates of insured single family loans for the two year period by beginning amortization date

Rank	Area	Quarter End Date	Total Orig.	Total Seriously Delinquent	Total Claims	Total Seriously Delinquent and Claims	% Seriously Delinquent and Claims
1	United States	03/31/2011	3,311,056	70,206	4,714	74,920	2.26
2	United States	12/31/2010	3,430,615	90,936	6,017	96,953	2.83
3	United States	09/30/2010	3,442,543	103,198	7,753	110,951	3.22
4	United States	06/30/2010	3,446,807	117,934	8,206	126,140	3.66
5	United States	03/31/2010	3,399,995	142,832	8,978	151,810	4.47
6	United States	12/31/2009	3,212,363	154,190	7,959	162,149	5.05
7	United States	09/30/2009	2,878,599	134,910	7,219	142,129	4.94
8	United States	06/30/2009	2,483,073	105,969	6,144	112,113	4.52
9	United States	03/31/2009	2,105,924	88,002	5,244	93,246	4.43
10	United States	12/31/2008	1,788,355	72,809	4,210	77,019	4.31
11	United States	09/30/2008	1,477,687	50,088	3,508	53,596	3.63
12	United States	06/30/2008	1,179,175	37,667	3,332	40,999	3.48
13	United States	03/31/2008	977,809	33,712	3,344	37,056	3.79

As the chart demonstrates, FHA's seriously delinquent rate deteriorated in late 2008 and 2009 even though total originations more than tripled. In Neighborhood Watch, when volume increases, performance should improve because new loans lack seasoning and are less likely to be seriously delinquent. Consequently, it was troubling that the seriously delinquent rate increased rapidly in 2009. It documents the poor performance of the 2007 and 2008 originations (particularly single family downpayment assistance loans).

Conversely, it is very encouraging that the serious delinquency rate has fallen precipitously in 2010 even though the origination volume leveled off and has started to decline. Some noteworthy points are:

- The number of seriously delinquent loans for loans originated in the respective two-year periods has fallen 54% (from 162,149 serious delinquencies in December 2009 to 74,920 loans in March 2011).
- In April, the number of seriously delinquent loans fell almost another 10% to 67,843 seriously delinquent loans.

- There are fewer recent originations in serious delinquency in March 2011 than were seriously delinquent in December 2008 even though there were over 1.5 million more FHA loans originated in the two-year period ending in March 2011.

- **FHA loans originated in 2010 are performing even better than loans originated in 2009.**
  - The seriously delinquent rate for loans originated in a one-year period fell from 1.23% in December 2009 to .43% in December 2010.
  - The one year performance numbers have continued to improve in 2011 as the seriously delinquent rate has declined to .38% for loans originated in the last year as of March 2011.

Below is a chart from FHA's Neighborhood Watch database that compares seriously delinquent rates for loans originated in the last year by quarter. (This feature was added to Neighborhood Watch in December 2009.)

All Lenders/Areas - Area Totals
United States Totals
Delinquent Choice - Seriously Delinquent
Performance Period - All Quarter End Dates
Loan Portfolio: 1 Year FHA
Sort Order by Quarter End Dates in Descending Order
Data shown includes all quarter end dates of insured single family loans for the one year period by beginning amortization date

Rank	Area	Quarter End Date	Total Orig.	Total Seriously Delinquent	Total Claims	Total Seriously Delinquent and Claims	% Seriously Delinquent and Claims
1	United States	03/31/2011	1,418,406	5,330	28	5,358	0.38
2	United States	12/31/2010	1,461,466	6,728	30	6,758	0.46
3	United States	09/30/2010	1,611,737	9,582	92	9,674	0.60
4	United States	06/30/2010	1,736,895	11,429	69	11,498	0.66
5	United States	03/31/2010	1,869,818	17,433	143	17,576	0.94
6	United States	12/31/2009	1,878,768	23,577	140	23,717	1.26

Like the two-year view described earlier, Neighborhood Watch's one-year view has improved steadily in 2010.

- The number of seriously delinquent loans for loans originated in the respective one-year period has fallen 77% (from 23,717 loans in December 2009 to 5,358 loans in March 2011).
- In April 2011, serious delinquencies fell to 5,097 loans.

- Since only 5,097 seriously delinquent loans (out of 1.4 million total loans) were originated in the last 12 months, it demonstrates that possible fraud or underwriting errors are also declining since those problems typically surface shortly after origination.

- **FHA has benefited both from insuring more higher quality loans and fewer loans with credit scores below 620 since 2008. (HUD Quarterly Report to Congress)**

  - FHA loans with credit scores above 680 have increased from 20% of FHA's originations in 2007 to almost 60% of FHA's originations in 2010.
  - FHA loans with credit scores over 720 now comprise 37% of FHA's originations. In 2007, they were about 10% of FHA's originations.

  - Why is this important?
    - FHA loans with credit scores above 680 and minimum downpayments perform better than loans with credit scores below 680 and 10% downpayments.

  - FHA loans with credit scores below 620 have declined from about 45% of FHA's business in 2007 to 4% in 2010.

  - Why is this important?
    - FHA loans with credit scores below 620 are the primary source of FHA claims because these borrowers are the most vulnerable to economic downturns.

While the FHA program has certainly not been immune to the impact of widespread house price depreciation, FHA is actuarially sound and is getting stronger. FHA's performance improved in FY 2010 and has continued to improve in FY 2011 in each of the four key financial barometers.

Source for this data: All data obtained from FHA reports on HUD's website @ http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/hsgrroom and FHA's Neighborhood Watch database @ https://entp.hud.gov/sfnw/public/

The reports are: 1) Quarterly Report to Congress on the Financial Status of the MMI Fund, 2) Actuarial Reviews, 3) FY 2010 Report to the Congress on the Financial Status of the MMI Fund, 4) FHA Outlook Reports, and 5) Monthly Reports to the FHA Commissioner.

Reasons for FHA's Excellent Performance

Of the reasons for the FHA's excellent performance, some are more obvious than others. FHA has certainly benefited from the leadership of the Secretary and his team at FHA (former Commissioner David Stevens, Acting Commissioner Robert Ryan and Deputy Assistant Secretary for Single Family Housing Vicki Bott). They have shored up FHA's balance sheet and strengthened risk management.

FHA Requires Verification of Income and Assets

Part of FHA's success is also attributable to the fact that it never insured new loans that did not require verification and documentation of borrower's income and assets. In addition, like any successful insurance company, it has considerable actuarial experience in pricing loans, adjusting premiums up and down as market conditions merit. As noted earlier, FHA has raised premiums four times in the last three years.

Lender Imposition of Credit Overlays

Several factors not readily apparent about the FHA program combine as effective checks and balances on lender actions. The impact is exemplified by the fact that lenders put their own underwriting restrictions (called credit overlays) on top of government restrictions. With credit overlays, lenders in effect are saying they are unwilling to originate certain loans that meet government underwriting criteria.

In late 2007, there was widespread concern that the FHA would become the "dumping ground" for subprime loans and, in fact, FHA did experience deterioration in credit quality at that time. The experiences of three top 10 lenders document this problem. One top 10 lender's average FHA FICO score dropped from 634 to 614 in the third quarter of 2007 compared with 2006. Another's average FICO score fell to 586 in November 2007. At a third, 22% of borrowers in November 2007 applications had FICO scores below 560. In response to this deterioration, mortgage lenders on their own, particularly the large purchasers of FHA loans, tightened underwriting guidelines (e.g. established credit score floors of 620 to 640).

Starting in early 2008, FHA's credit quality began to improve steadily. In the fourth quarter of 2007, 47% of FHA borrowers had credit scores below 620. In virtually every quarter since then, the percentage of loans to borrowers with credit scores below 620 has fallen and is now about 3% of FHA loans (excluding streamline refinances). In actual number of loans, the change is equally significant. In 2007, FHA insured about 150,000 loans with credit scores below 620. In 2010, FHA insured less than 50,000 loans with credit scores below 620 even though FHA activity was approximately four or five times FY 2007 levels.

Why do lenders put credit overlays on loans with 100% government insurance?

Though it may surprise some, the FHA already has its versions of risk retention ("skin in the game") and transparency. First, unlike alternative-A and subprime products, in which the risk was mispriced and the value of the loan was in its "origination" and sale in the secondary market, the ultimate economic value of an FHA loan is in the monthly servicing fee (an annuity-like payment) on a performing loan. In short, long-term loan performance matters in the FHA program.

Since the primary economic value of an FHA loan is the monthly income collected by the servicer, not origination fees, the FHA program, in effect, has a performance-based compensation system. This "deferred compensation," coupled with the consolidation of FHA servicing (five lenders service more than 70% of FHA loans), means that a small group of large financial institutions will have invested an estimated $4 billion this year to buy FHA originations from smaller lenders and mortgage brokers. To protect their investments, these servicers have incentive to monitor originator performance.

And since FHA cannot rely on business self-interest alone to ensure that all lenders act responsibly, it has also developed enforcement tools, including indemnifications (FHA's "repurchases") and, arguably even more important, the public announcement of any FHA sanction. For large public companies, a publicized FHA action brings "headline risk" and unwanted investor scrutiny. For smaller companies, it prompts inquiries from important business partners (warehouse lenders, servicers). In short, reputational risk has always existed in the program and is paramount today because of FHA's higher enforcement focus.

Reputational risk is also on public display in FHA's Neighborhood Watch database that tracks early default and claim loan performance. In addition to targeting FHA audits and sanctioning lenders with high default rates, this database lets business partners, Congress, the press and public examine individual lender performance in any state, city or ZIP code in the country. Taken together, the "backloading" of loan compensation, reputational risk and transparency strongly influence lender behavior. Put another way, it is in the industry's self-interest to originate well-underwritten FHA loans.

While there is certainly little sympathy for the lender’s plight in the housing crisis, I would be remiss if I did not mention that overlays also occur because the industry believes that there has been an overzealous use of sanctions by the government (primarily loan repurchases and now possibly significant penalties for servicing deficiencies). In the industry’s view, one of the only ways to combat the government’s approach to enforcement is to not make loans with a higher level of risk. (Lender concern is government-wide and not directed specifically at FHA.)

While some may view overlays as a way to further reduce risk in the system, they are lessening the value of government participation in the mortgage market and are having an adverse impact on the housing and economic recovery.

Ginnie Mae Program

Ginnie Mae is a monolined business focused solely on guaranteeing securities. Unlike Fannie Mae or Freddie Mac, it does not purchase loans and then issue securities. Its guaranty protects investors only.

As Ginnie Mae President Ted Tozer said in testimony before this Committee,

> "Ultimately, before Ginnie Mae's guaranty is at risk, three levels of protection must be exhausted: 1) homeowner equity, 2) the insurance provided by the government agency that insured the loans and 3) the corporate resources of the lender that issued the security. We are in the fourth and last loss position."

Like FHA, Ginnie Mae issuers (approved FHA lenders) have "skin in the game" since the lender who created the security remains financially responsible for the performance of the security. If borrowers miss their mortgage payments, the issuer must still advance the full principal and interest to Ginnie Mae every month. This financial liability is another reason why FHA lenders have put overlays in place on FHA and other government loans.

Ginnie Mae's finances are in excellent shape

Ginnie Mae earned more than $500 million in FY 2009 and FY 2010 respectively. It holds a $1 billion loss reserve and $14 billion in capital.

IV. Proposed reforms in Discussion Draft

Background

Before discussing the specific proposals, it is first appropriate to review the basic tenets of the FHA program and their impact on FHA's overarching objectives of assisting homebuyers not adequately served by the private sector while operating at no expense to the American taxpayer.

First and foremost, FHA is an insurance program. Like any successful insurance program, the FHA program must spread its risk across a broad enough group of borrowers to compensate for losses that will inevitably occur on some loans. Just like an auto insurer cannot be limited to drivers under the age of 25, FHA cannot be limited to borrowers with higher risk characteristics.

At the same time, FHA must balance the need to diversify its risk in order to protect the American taxpayer with the legitimate concern about the government encroaching too far into the private mortgage market. To address this issue, the Congress has used reasonable mortgage limits and a uniform premium structure to target FHA participation.

The challenge with mortgage limits in the FHA program is that higher balance loans perform better than lower balance loans. In the FY 2010 audit, it states

> "FHA experience indicates that more expensive houses tend to perform better compared with smaller houses in the same geographical area, all else being equal. The average houses in the marketplace, which have been the larger houses having FHA-insured mortgages, incur claims at a lower rate than smaller houses."

Concerning the FHA premium structure, unlike most insurers that charge insurance premiums based on risk (risk-based pricing), FHA charges all borrowers, with the same loan terms, the same mortgage insurance premium. In this way, borrowers with better credit characteristics enable FHA to assist borrowers who are in most need of FHA support. This principle of "cross-subsidization" also minimizes overlap with the private sector by "overcharging" borrowers with lower risk characteristics.

A risk-based premium structure has been debated for many years. In 1987, the Mortgage Bankers Association of America asked KPMG Peat Marwick to analyze the risk-based premium issue. KPMG stated:

> "By choosing this approach (risk-based premium), the FHA would have to charge premium rates that vary by as much as 300 percent to 400 percent from the lowest rate (e.g. low loan to value, high valued home) to the highest rate (e.g. high loan-to-value, smaller than average mortgage loan amount.)

The KPMG study supports the concept of "cross-subsidization". It keeps premiums lower for homebuyers who rely on FHA the most and "overcharges" lower risk borrowers. In addition, the KPMG study also confirms that higher balance loans have performed better than lower balance loans for many years.

In conclusion, any changes to the FHA program must balance the need to ensure FHA's financial soundness with the concerns about unnecessary overlap with the private sector.

Comments on Proposed Reforms in the Discussion Draft

I would like to provide specific comments on the following sections of the Discussion Draft. They are:

- Section 3 - FHA downpayment requirement of 5%

As the current FHA data presented earlier indicate, the performance of the FHA portfolio is improving. (Many FHA loans have downpayments of 3.5% or less). The Congress has already addressed the problem with FHA downpayments when it terminated the seller funded downpayment assistance program in 2008 and also raised the minimum cash investment requirement to 3.5%.

In addition, in a hearing before this sub-committee in March of last year, then-FHA Commissioner Stevens noted that the FHA volume would be reduced 40% if downpayments were increased to 5%. He also noted "downpayment alone is not the only factor that influences FHA performance". In fact, a low downpayment loan with a credit score over 680 performs better than a 10% downpayment loan with a credit score below 680.

Below is an excerpt from his written testimony.

> "Some have suggested that FHA raise the minimum required downpayment to 5% across the board and also remove the option of financing the upfront insurance premium into the loan balance for all transactions as a means to increase homeowner equity. We share the goal of increasing equity in home purchase transactions, but determined after extensive evaluation that such a proposal would adversely impact the housing market recovery.
>
> To determine the impact of requiring a minimum 5% downpayment for all transactions, FHA evaluated the loan files of a large sample of past endorsements to identify the number of borrowers who had sufficient assets at time of loan application to contribute the additional 1.5% of equity at closing. As illustrated in the table below, such a policy change would reduce the volume of loans endorsed by FHA by more than 40%, while only contributing $500 million in additional budget receipts. This translates to more than 300,000 fewer first-time homebuyers and would have significant negative impacts on the broader housing market - potentially forestalling the recovery of the housing market and potentially leading to a double-dip in housing prices by significantly curtailing demand. In contrast, the combination of policy changes proposed by FHA in the FY 2011 budget would contribute an additional $4.1 billion in additional receipts to FHA while having a much more moderate impact on the broader housing market."

"Impact of FY 2011 Policy Options on FHA Receipts and Loan Volume

Policy Option	FHA Receipts ($ Billions)	FHA Loan Endorsements ($ Billions)
Baseline without policy changes	$1.7	$246
Minimum 5% downpayment for all transactions	$2.2	$139
FY2011 Budget Proposal with all proposed policy changes	$5.8	$223

Furthermore, downpayment alone is not the only factor that influences loan performance. The combination of downpayment and FICO score is a much better predictor of loan performance than just one of those components alone. For instance, loans with a loan-to-value (LTV) above 95% **and** a FICO score above 580 perform better than loans with LTV below 95% **and** a FICO score below 580, while loans with a LTV above 95% **and** a FICO score below 580 perform significantly worse than all other groups, as illustrated below.

FHA Single Family Insured Loan Claim Rates Relative Experience by Loan-to-Value and Credit Score Values				
Ratios of each Combination's Claim Rate to that of the Lowest Risk Cell[5]				
Loan-to-Value Ratio Ranges	Credit Score Ranges			
	500-579	580-619	620-679	680-850
Up to 90%	2.6	2.5	1.9	1.0
90.1 - 95%	5.9	4.7	3.8	1.7
Above 95%	8.2	5.6	3.5	1.5

Source: US Department of HUD/FHA; March 2010.

- Section 4: FHA mortgage limits

While current temporary mortgage limits are set to expire in September 2011, this proposal would significantly lower FHA limits in many sections of the country by setting limits on a county by county basis. This proposal raises serious concern for three reasons. First, it would be an administrative "nightmare" to manage individual limits in over 3,000 counties. FHA mortgage limits could vary across streets in neighborhoods that are in different counties. In recent years, Congress had taken steps to address this problem by establishing mortgage limits for metropolitan areas. This proposal would reverse that approach.

Second, it will have the effect of increasing costs of homeownership for many families at a time when demand for housing is so weak. While FHA has raised its premiums to the highest levels in its history to protect the insurance fund, the GSEs have raised their fees even higher for homebuyers with better risk characteristics. (Private mortgage insurance fees are comparable to FHA depending on loan-to-value ratio.)

Finally, and arguably most importantly, lowering the FHA maximum loan amount to the extent contemplated in the proposal will have a negative effect on FHA's financial

solvency. As noted earlier, higher balance FHA loans perform better than lower FHA balance loans all else being equal.

- Section 5 - FHA annual mortgage premiums

Since FHA no longer pays distributive share payments to homeowners after their FHA loan is terminated, I would oppose setting a minimum insurance premium. Over the years, FHA leadership has demonstrated that they will act responsibly in setting insurance premiums. An arbitrary minimum is inappropriate (unless FHA's mutuality feature is reinstated).

- Section 6 – Indemnification of mortgages

The Department should have the authority to require indemnifications for serious violations of the program requirements. I would encourage the Department to finalize its proposed rule on indemnification policy. In the proposed rule, FHA outlines the criteria for indemnification including the fact that the violation is "serious and material". Otherwise, the legislative provision could precipitate more overlays as lenders would be concerned that FHA, at some point in the future, could require indemnifications on minor administrative errors.

- Section 8 – Authority to terminate FHA mortgagee origination and underwriting approval

Similar to Section 6 above, FHA should have the authority to terminate FHA mortgagees for excessive early default and claim rates. Responsible lenders share the Congress' concern about poor performing lenders jeopardizing the FHA's finances and they are also frustrated to have to compete with such lenders in the marketplace.

However, it does raise questions about the evaluation process. Currently FHA's Neighborhood Watch database, which is the source for the early default data, does not distinguish between risk categories (for example credit scores or product type). Using credit scores as an example, FHA's average credit score is over 700. Accordingly, if a lender wanted to assist a borrower with credit issues, its performance would be compared to the FHA average (i.e. 700 credit score). It is highly unlikely that these loans will perform as well as the average FHA loan with a much higher credit score. There needs to be an "apples to apples" comparison process. Otherwise, FHA lenders must manage to the FHA average credit profile to minimize potential risk.

While both enforcement initiatives are reasonable (if implemented properly), they could encourage responsible lenders (that the provisions were never intended to affect) to tighten guidelines (i.e. more overlays) to protect their companies from potential financial/reputational risk.

- Section 9 – Authorization to participate in the origination of FHA-insured loans

This provision will enable community banks to more easily participate in the FHA program. It is administrative in nature and creates no additional risk for the program.

- Section 10 – Deputy Assistant Secretary for Risk Management and Regulatory Affairs

We have already seen the value of this position in the performance of Mr. Robert Ryan.

Other legislative and regulatory suggestions for the Subcommittee's consideration

1. I would add more transparency to the FHA program. Specifically FHA should be provided the funding to track early default loan performance by individual loan officers. If individual loan originators recognized that the performance of their originations would be tracked by the Department and available to the public, it would make loan originators much more sensitive to loan quality and reduce the potential for fraud and abuse. Presently, the poor performing originators simply move from one company to another after a problem is exposed. In this way, potential employers could see their performance.

2. FHA is considering changes to reinstate the Section 203 (K) investor program. FHA's investor problems in the 1990's were tied to non-profits. This change will facilitate the renovation of the housing stock.

3. FHA is also considering changes to its existing condominium program. The performance of existing condominium loans has been better than other "stick built" homes. FHA can rely on local approvals of existing condominiums.

4. In recent months, there has been discussion about changing servicing compensation levels to encourage better servicing of defaulted loans. In light of FHA's experience, I would be concerned that lowering the servicing fee on performing FHA loans would discourage loan quality. Servicers would no longer have a financial incentive to purchase quality loans. In fact, it would be in their financial interest to purchase loans more likely to default.

   I would also recommend the subcommittee consider a special program for the hundreds of thousands of homeowners who are still current on their loans but have been unable to refinance their homes and take advantage of lower interest rates because their homes are significantly underwater. These homeowners have "played by the rules" but have not been able to refinance solely because of matters outside of their control (their property value has declined). FHA could set up a separate program (not part of the Mutual Mortgage Insurance Fund) and charge appropriate premiums for the risk. I also think there was a study

conducted in the Massachusetts area in early 1990's that found these loans performed extremely well. The property declines today are probably much more significant than occurred in early 1990's.

I know there are numerous hurdles to implementing a program of this type (e.g. pricing in secondary market), but it would be extremely helpful to many Americans who happened to buy a home at the wrong time.

In conclusion, FHA's performance indicates that, with full documentation, low-down-payment loans can be made on an actuarially sound basis. FHA's results counter the view that it was the GSEs' public purpose that precipitated their losses. FHA's portfolio is filled with a much higher share of loans with minimal down payments and lower credit scores than the GSEs acquired at the peak of the housing bubble. Unfortunately, as the GSEs' market share declined from 70% in 2003 to 40% in 2006, they responded to private-sector pressures by mirroring their products (e.g. low or no documentation, interest only and option ARMs).

Transparency is a strong deterrent to bad lending practices. It only takes a few well-publicized enforcement actions to reverberate throughout the industry and hurt reputations. FHA's data transparency (Neighborhood Watch) also gives business partners and the public the tools to evaluate originator performance.

The "originate to distribute" model and securitization have worked in the FHA/Ginnie Mae programs. However, they must be accompanied by "skin in the game, originator/issuer accountability and transparency. It is important that someone (issuer/servicer) in the mortgage process has long-term compensation incentives. It does not necessarily have to be the loan originator.

The mortgage market has been devastated by the financial equivalent of the 100-year flood. Yet the FHA, with all its limitations, is still operating without taxpayer assistance. As the Subcommittee looks for solutions to the problems facing the housing market, seeing what is working in the FHA program may be helpful in its deliberations.

Thank you for the opportunity to participate at this hearing. I will be pleased to answer any questions that you may have.

United States House of Representatives
Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	**2. Organization or organizations you are representing:**
Brian Chappelle	Potomac Partners, LLC
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature: [signature]	

Please attach a copy of this form to your written testimony.