

**Testimony of  
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Of the Committee on Financial Services  
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**“Sustainable Housing Finance: Perspectives on  
Reforming FHA”**

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## **Introduction**

Chairman Neugebauer, Ranking Member Capuano, and Members of the Committee, thank you for the opportunity to testify on how to reform the Federal Housing Administration (FHA). I am currently an Executive-in-Residence and Tyser Teaching Fellow at the Robert H. Smith School of Business at the University of Maryland. Prior to my role at the University of Maryland I spent more than 20 years at major financial institutions managing or leading risk management functions.

My testimony today focuses on the effectiveness of FHA's structure, its policies, risk assessment and operational capabilities to ensure the long-term financial sustainability of its programs. In addition, I highlight several recommendations that would secure the financial viability of FHA while also clarifying and sustaining its role in the housing finance system. These include placing FHA into a new federal corporation; development of a set of countercyclical policy targets for determining when FHA should scale up during periods of economic stress and when to contract when conditions improve; application of area median income targets to better define its mission; development of more robust risk surveillance capabilities, introduction of risk-based pricing and development of private risk-sharing arrangements consistent with other segments of the housing finance system.

Unquestionably, FHA has served a critical role in our nation's housing market by providing affordable credit to over 40 million first-time homebuyers and other borrowers with limited resources that would otherwise have difficulty obtaining access to credit through more traditional private sector sources. The recent financial crisis and its aftermath underscored the importance of FHA's countercyclical role in providing much needed liquidity and credit to mortgage markets reeling from the withdrawal of private capital during this period. At the same time, FHA in its capacity as public steward of the \$1 trillion plus Mutual Mortgage Insurance Fund (MMIF) has responsibility for maintaining the financial integrity of that fund which according to recent actuary analyses has lately experienced considerable stress.

The current state of the MMIF can be directly attributed to a lack of clarity in the scope of its programs, mission conflict between maintaining actuarial soundness of the MMIF and advancing homeownership opportunities to prospective borrowers, a lack of resources to effectively identify, measure and manage risk consistent with an insurance fund of the scale and complexity of the MMIF and a lack of systematic and proactive countercyclical policy mechanisms to guide the agency as economic circumstances change. The question for policymakers is what changes should be made to FHA that provide the agency with the best opportunity to fulfill its critical mission to housing while also protecting the taxpayer? Before proceeding to a set of specific recommendations, it is important to highlight a number of contributing factors to FHA's current financial situation and their implications for markets, borrowers and the MMIF today.

## **Contributing Factors to FHA's MMIF Fund Challenges**

### Mission Conflict

In addition to providing access to affordable credit for traditionally low- and moderate-income borrowers typically with lower net worth; FHA is required to maintain the MMIF to a congressionally mandated capital reserve ratio of 2%. Specifically, that means that the economic value of the MMIF net of expected future losses must be at least 2% of the total amount of loans insured by FHA. According to the latest actuary results for 2012, that ratio stands at approximately -1.44 percent. The fact that the MMIF's economic value stands at negative \$16.3 billion is evidence that FHA's social mission has overshadowed its financial mission. FHA's experience is in a number of ways similar to that of many private mortgage lenders in the years during the housing boom, when market share objectives came at the expense of significant risk-taking. We now realize that for banking a focus on market share without a healthy appreciation for risk was a recipe for disaster and the lessons learned from this experience are as important for FHA, Fannie Mae and Freddie Mac as they are for the private sector. At the heart of this issue are a host of governance, operational and oversight issues that explain excessive risks borne by FHA over the years.

These twin objectives for FHA at times may be in conflict. For example, in 2010, FHA imposed a minimum borrower credit score (FICO) of 580 as a way of improving the credit quality of new business. Up to that point, the lack of minimal standards on borrower creditworthiness clearly helped FHA expand its reach to borrowers with especially poor credit while significantly raising the risk to the MMIF. The mortgage industry has for years understood that borrowers with such marginal credit history tend to have a likelihood of default on their mortgage that may be as much as 5-8 times higher than that of borrowers with FICO scores of 700 and above, for example. Moreover, FHA can use its pricing of Mortgage Insurance Premiums (MIPs) to affect desired public policy outcomes to serve its perceived social mission. For example, by holding down MIPs below what otherwise would be actuarially sound levels it blunts costs to homeowners while passing them onto the MMIF through higher credit losses that manifest over time. Such policies allow FHA to serve a larger segment of the borrower population, but expose the MMIF to much higher risk. Conversely, setting credit policies too high prevents certain borrower segments from obtaining credit through FHA's various programs. Striking the right balance between FHA's social mission and its duties to maintain the MMIF's financial integrity is complicated and made more difficult by a lack of clarity in defining who its target borrowers are. Such an exercise is about determining what segments of society merit public support as well as about establishing a clear risk appetite that aligns to these goals.

### Lack of Defined Risk Appetite

Standard practices today for commercial banks include an articulation of a bank's tolerance for risk-taking. The risk appetite of a bank is like a compass, providing direction to the

rest of the company as to what prudent risks should be taken, or conversely what risky activities to avoid. Risk beyond these stated levels are unacceptable and actions would need to be taken to bring a bank back into compliance. As market and product risks change over time, the risk appetite provides the firm with an effective mechanism for maintaining a consistent level of risk-taking. For FHA, no such risk appetite was set over the years.

### Lack of Mission Clarity

Turning to the social policy aspect of FHA programs, FHA's traditional role of serving low- and moderate-income borrowers has expanded into borrower segments that have access to private sources of credit by virtue of loan limits that currently allow higher income borrowers to obtain an FHA mortgage. Reliance on loan limits to determine FHA borrower eligibility rather than on income measures expands federal subsidies to borrower classes that do not need such benefits.

To underscore the policy impact of current FHA loan limits, consider the following example. A borrower in the Los Angeles Metropolitan Statistical Area (MSA) can obtain a loan amount of \$729,750. Given prevailing mortgage rates for a fixed-rate 30 year amortizing mortgage and including associated taxes and insurance on an \$800,000 property, the monthly mortgage payment would be about \$4,175. If the loan met the Consumer Financial Protection Bureau's (CFPB) new Qualified Mortgage rules, the borrower would need to have a monthly income of approximately \$9,700, or an annual income of about \$116,400. And the income requirements would be even higher if this borrower carried nonmortgage debt obligations. This income level far exceeds the 2012 median family income estimate for LA of \$64,800. While FHA continues to serve many low- and moderate-income borrowers today, there clearly is a need to revisit the social and economic rationale for current FHA loan limits as well as consideration for implementing income-based limits.

Operating as an agency within HUD, FHA's financial mission appears to have been relegated to a second order objective over time to the department's stated mission to create strong sustainable communities and quality affordable homes for all. Nowhere in HUD's mission statement does the objective of also ensuring effective financial management of one of the largest insurance funds in the world appear. This apparent imbalance in the strategic focus of HUD only now manifests itself in the form of the MMIF's current financial predicament due largely to the unprecedented crisis in the mortgage market; however, it has taken decades to get to this point over different administrations. In fact, this Administration is to be commended for its quick actions over the last several years to raise premiums, enact tighter credit standards and otherwise bolster risk management. Unfortunately, these initiatives come well after extranormal risk has been taken and have not gone far enough. Moreover, these measures are reactive and not intended to address systemic issues in how FHA operates.

## Underinvestment in Risk Management

One manifestation of the heightened focus of FHA on its social mission to the detriment of the MMIF is the historical underinvestment in risk management resources, personnel and technologies essential to managing a fund of such scale as the MMIF. In a way, the focus on maintaining market presence by FHA was not unlike that which affected many mortgage lenders during the housing boom and with similar consequences in terms of credit losses well in excess of expected levels. And although FHA undertook an initiative to transform its risk management processes that is still underway today, in a study by the Government Accountability Office (GAO) conducted in 2011, a number of critical deficiencies in FHA's ability to effectively manage risks were identified. These included staffing shortages in key risk management areas, a lack of adequate systems and capabilities to conduct proper surveillance of emerging risks and threats to the MMIF, delays in obtaining much needed resources and high turnover among key positions. Such findings are the hallmark of an organization not well-equipped to quickly identify, measure and manage risks. These weaknesses further exacerbate adverse selection taking place against FHA, resulting in the agency absorbing excessive risk that it had little ability to identify before it had already been booked.

To put FHA's risk infrastructure into perspective, if the agency were subject to regulatory oversight by one of the bank supervisory agencies it is likely that FHA would be subject to a number of examination findings on its risk management activities. In assessing an institution's risk infrastructure, bank examiners focus on a number of critical areas including the quality of an institution's governance structure for risk management, the adequacy and competence of risk staff, quality of reporting, policies and procedures, data management and analytic capabilities, among others. A widely held perspective among bank regulators is that an institution's risk infrastructure must grow ahead of its lending activity. Without such attention to the quality of the risk management process, an institution or agency in this case would be severely handicapped in an accelerated growth scenario as FHA has experienced in recent years.

In the case of FHA, chronic underinvestment in staffing and technology greatly contributed to the stress placed on the MMIF. The GAO identified critical technology needs in several areas spanning FHA's risk management processes. These included improvements to its automated underwriting system used to evaluate individual loan and borrower quality in an integrated way, the need for FHA to acquire an automated valuation capability to systematically assess collateral value, development of a suite of fraud detection and prevention tools, and an overhaul of the underlying systems capturing FHA data. These are all capabilities that Fannie Mae, Freddie Mac and large sophisticated portfolio lenders have developed as part of their risk management framework and should be expected of FHA as well.

Lacking such capabilities to assess risk at a more granular level during the housing boom severely handicapped FHA as mortgage products underwent a radical and risky transformation from the way they had been underwritten historically. The proliferation of subprime and Alt A

mortgages forced FHA as well as Fannie Mae and Freddie Mac into a type of mortgage market mutual assured destruction scenario where the agencies significantly relaxed credit standards and pricing in an effort to maintain market share against private lenders. Concurrently, underlying changes in risk attributes due to ongoing shifts in borrower behavior toward debt obligations would ultimately lead to much higher credit losses than predicted. Relaxation of underwriting standards facilitated new combinations of risky attributes such as extremely low FICO scores coupled with high LTVs and programs such as the Downpayment Assistance Program for which FHA had little or no historical experience to base pricing adjustments which in turn led the agency to grossly underestimate the level of credit risk in these loans.

In addition, FHA has historically underinvested in robust portfolio surveillance capabilities. Once a loan has been originated, portfolio lenders retaining the asset on balance sheet typically engage in a number of activities to track the loan's default and loss performance against modeled outcomes over time and report material changes in defaults and losses to senior management. Changes in the economy, housing market and individual borrower behavior must be closely monitored. Such early warning mechanisms serve as the basis for effective remediation efforts to avoid default, adjust pricing, credit and collateral policies as well as trigger portfolio-level risk mitigation activities. These capabilities are core to any large portfolio lender's risk function and are staffed with highly skilled risk professionals trained in advanced credit portfolio valuation techniques. Such techniques provide firms with an ability to more accurately assess and price credit risk by allowing combinations of risk attributes to be examined collectively across multiple economic scenarios over time. Without these portfolio tools, FHA finds itself at a distinct disadvantage vis a vis mortgage lenders that optimize the loan's disposition between FHA and other alternatives such as holding the loan in portfolio, or selling the risk to Fannie Mae or Freddie Mac by using sophisticated credit pricing models. Such disadvantages in risk pricing facilitate riskier pools of loans being insured by FHA.

### One Size Fits All Pricing

One way FHA inadvertently incurs higher credit risk in the MMIF is by its approach of average pricing credit risk. With the advent of automated underwriting systems and associated enhancements to pricing models, lenders refined their pricing of risk to specific attributes such as loan-to-value ratio (LTV) and FICO score categories, among others. By introducing a tiered pricing structure based on statistically significant differences in credit risk between groups, lenders were able to more accurately price risk, notwithstanding aggressive risk-taking behavior that led to the mortgage crisis. These practices came at the expense of FHA which by utilizing a "one size fits all" flat-rate premium pricing structure allows low risk borrowers to effectively subsidize high risk borrowers. Over time, lower prices charged by government-sponsored enterprises (GSEs) and lenders for loans with low default risk profiles shifted these loans away from FHA and into conventional loan financing, leaving FHA with an increasingly higher risk profile. Thus FHA's reliance on average pricing coupled with limited flexibility to determine premiums based on inherent risk exposure contributed to the MMIF's financial challenges.

## Lack of Systematic Countercyclical Policies

In theory one of FHA's virtues is its ability to provide a countercyclical role as economic conditions change. During favorable economic periods, FHA's footprint may be lower as private capital enters the market. However, under periods of economic stress, private capital may evaporate, and FHA's ability to scale up its activities may help limit the extent of a market downturn. This is exactly what happened in the years leading up to the housing crisis and afterward. However, this countercyclical role performed by FHA during these divergent economic periods was less attributed to any systematic policies and triggers designed to proactively respond to changes in market conditions than to a host of issues that put FHA at a competitive disadvantage to other mortgage executions. As the crisis was just beginning, FHA's limited pricing and credit policy response to emerging market events led to a sharp increase in its market share just as lenders and mortgage insurance companies were tightening credit policy and raising delivery fees and other premiums. And more than 5 years after the crisis began FHA's market share remains significantly above historical levels of 10-15 percent due to relatively high loan limits and premiums that crowd out private capital in the mortgage market.

One of the important lessons from the mortgage crisis was that public policies developed during a crisis often time lead to suboptimal outcomes and unintended consequences. A corollary to this lesson is that a proper role for government is to moderate extreme market movements that may come about due to abnormal market behavior. Thus FHA has a third mission; namely to provide a countercyclical balance to the mortgage market. However, effective execution of this important role requires development of a systematic set of policies and triggers in advance of any emerging threats to market stability.

## **Recommended Reforms to FHA**

Ensuring the long-term viability of the MMIF while clarifying FHA's mission can be achieved by implementing a number of reforms aimed at addressing the contributing factors to the current challenges facing FHA. These reforms start with clarifying the role of FHA vis a vis other market participants, restructuring FHA to provide the agency with the flexibility and tools to manage its risks, strengthening its risk management capabilities, and development of new risk-sharing and pricing frameworks to limit risk exposure and accurately price risk.

### Provide Mission Clarity

Clarifying FHA's role must begin by taking a comprehensive view of housing finance reform. Complicating effective reform of FHA and the GSEs is the fact that this country has no national housing policy. Rather than implement reforms isolated to each market, policymakers should first consider what the target market is for FHA loans and once determined assess how federal guarantees relate to the rest of the mortgage market. One of the outcomes from the

mortgage crisis was that the market was essentially fragmented but blurred along three artificial lines; FHA, GSE, and private issuers. Over time this market segmentation, coupled with relatively underdeveloped risk and pricing capabilities at FHA, facilitated adverse selection against the agency as lenders optimized the disposition of loans according to their highest value, leaving FHA the clear choice for the riskiest loans.

First and foremost, FHA needs to get back to its historical roots of focusing on providing access to mortgage credit for low- and moderate-income borrowers. The size of the market should ideally be no greater than FHA's historical share of 10-15 percent in a normal market. Achieving this target over time must be done gradually so as to not disrupt the mortgage market. For years median income targets have been used in various affordable housing programs. For example, the Federal Home Loan Banks' Affordable Housing Program (AHP) provides subsidies to borrowers with median incomes at or below 80 percent of area median income. Likewise, affordable housing goals for both GSEs use the same 80% threshold of area median income in defining targets for Fannie Mae and Freddie Mac. FHA should adopt an area median income target to determine program eligibility and phase out the use of area-based loan limits. In conjunction with establishing income-based eligibility requirements, FHA should strengthen its requirements to ensure all eligible borrowers have the best chance of staying in their homes. This comes down to raising the bar on collateral, credit and capacity criteria to repay the mortgage; namely, the 3Cs of underwriting. I would recommend that FHA require a downpayment of at least 5 percent for all lending programs, establish a minimum FICO of 620 and impose a residual income requirement similar to that used by the Veterans Administration.

### Restructure FHA

Compared to other large federal, GSE and private insurers FHA has historically struggled with securing sufficient resources to manage its risks. Back at FHA's inception in 1934, no one would likely have imagined that the MMIF would have reached the \$1 trillion mark. However, today there is an unsustainable gap between the resources needed to effectively manage the fund and FHA programs and the magnitude of insured risk. In order to attract the right resources to manage its risks, FHA requires greater flexibility and resources to compete with other agencies and private sector employers for risk talent. Today the agency is fortunate that FHA's employees are highly committed to the mission, however, the agency must strengthen its risk infrastructure along many dimensions starting with its human capital.

An optimal structure for an agency the size of FHA would be to establish it within a new federal corporation overseen by a commission comprised of the heads of various federal agencies with housing and mortgage responsibilities and chaired by the HUD Secretary. This entity would bear some resemblance structurally to the Federal Deposit Insurance Corporation. Such a structural arrangement would yield a number of benefits for FHA specifically and housing markets generally.



First, this new corporation would be self-funded off of assessments on loans it insures not unlike what the banking regulatory agencies and GSEs do today. As a result, FHA would finally have the resources needed to manage its risks. Second, the new corporation provides a structure for a post-GSE secondary market that could align pricing and policies in a consistent fashion across markets. Third, the new corporation would mitigate potential conflict between the agency's social and financial missions. By setting the agency up outside of HUD it reduces incentives for future administrations to impose policies on FHA that limit pricing flexibility and/or attract risks beyond target levels. Fourth, the new corporation provides a vehicle for establishing a systematic set of countercyclical policies that can be implemented quickly when required. Fifth, the structure enhances oversight of the operations of a critical part of the housing finance system as well as brings together the various federal agencies with mortgage oversight responsibilities and/or regulated entities with housing-related activities. In a sense the corporation's commission would act as a type of Financial Stability Oversight Council (FSOC) for the housing market which has desperately needed more formal policy integration across federal agencies. Sixth, the new corporation would provide a mechanism for maintaining consistency in key credit policies. Today, rules determining eligibility for qualified mortgage lending are scattered across various federal agencies. This perpetuates policy fragmentation across the mortgage market which leads to policy confusion and inefficient policy implementation. The corporation should have authority to establish, monitor and manage such credit policies under the auspices of the commission. Lastly, FHA's mission to provide access to credit for low- and moderate-income families would not be marginalized under this proposed structure. The HUD Secretary acting as chair of the corporation commission assures that this mission remains central to the work of FHA. At the same time, a commission ensures balance between the often competing social and financial missions of FHA.

#### Formalize FHA's Countercyclical Role in Markets

Formalizing FHA's countercyclical role should be a priority for any reform of the agency. As described earlier, applying ad hoc changes in premiums, loan limits and other policies during a crisis can introduce confusion to markets and yield outcomes that are not intended. Raising loan limits, for instance during the crisis at first glance provided a mechanism for quickly allowing FHA to support the mortgage market at a critical time, however, it also expanded the eligible borrower population to people that have ready access to credit. Moreover, there currently is no mechanism in place to systematically scale back FHA's market expansion. This policy vacuum essentially postpones any market realignment from occurring that would allow private capital to return in substance.

A set of countercyclical policies and practices should be developed. Taking a cue from the Federal Reserve's targeting of key macroeconomic factors in developing its monetary policy, a set of policy targets for housing and mortgage markets would provide FHA with clear direction on when to expand and contract its business. Such policy targets as local market home price trends, market credit spreads on mortgage securities, and other pertinent housing and mortgage

metrics could provide FHA with direct feedback on the health of these markets. The agency in turn would have the authority with approval of the commission to implement specified policy changes designed to temporarily adjust FHA's programs. Specific triggers with well-defined ranges for each policy target would provide a roadmap for when certain prescribed actions would take place. And the commission could be the final arbiter in any policy action, overriding the policy targets as needed based on their informed judgment at the time. Such a framework would provide needed structure as well as policy flexibility and responsiveness as market conditions change.

### Allow FHA to Engage in Risk-Sharing Arrangements

Unlike many other holders of credit risk, FHA has no formal mechanism to transfer credit risk to the capital markets. As a result, FHA winds up holding 100 percent of the credit risk even though it may be economically advantageous to engage in risk-sharing arrangements with various market participants. For instance, both GSEs are required to have suitable credit enhancement for loans above 80% LTV. Private mortgage insurers provide first-loss coverage depending on the LTV between 25-35 percent. Such arrangements allow the GSEs to distribute risk across other counterparties rather than concentrate risk on their balance sheet.

Credit enhancements are also effective for reshaping the risk profile of the existing insured book. For example, large portfolio lenders and the GSEs from time to time will enter into reinsurance contracts with approved counterparties to sell portions of credit risk in their loan portfolios. Best practice portfolio risk management exercises are not static but rather make regular adjustments to the risk profile of the insured book as market conditions or loan performance is anticipated to change. FHA should have the flexibility to enter into such arrangements.

Currently, the FHFA has embarked on a credit enhancement pilot with both GSEs to contract their balance sheets and this initiative will also provide insights into what credit structures appear operationally and economically most viable. As a way of both reducing the risk of the MMIF and initiating experience with such structures, FHA should begin to selectively test a variety of credit enhancements. However, in order to engage sophisticated investors in credit risk transfer structures, the agency will need to build its analytical, data and credit structuring capabilities well beyond what is in place today.

### Strengthen FHA Pricing

FHA also needs to enhance its MIP pricing capabilities. These activities are dependent on robust pricing models and accurate data that can provide a granular assessment of credit risk. With such capabilities, FHA should begin to deploy risk-based pricing matrices that differentiate risk across various categories of risk attribute such as LTV, FICO and product type. Likewise, the agency needs to be able to adjust pricing that reflects important shifts in underlying credit risks when market conditions and risk profile changes.

### Establish FHA's Risk Appetite

In clarifying FHA's social mandate, the agency should define that role conditional on a prescribed risk appetite. The risk appetite framework should articulate that the agency seeks to insure loans for creditworthy low- and moderate-income borrowers that have personally put up equity for the home. The risk appetite should also outline a target expected loss for the MMIF over time as well as a target maximum loss level with some level of confidence. Such metrics are commonly used by large financial guarantors in managing their risk and given the size of the MMIF should be introduced formally into FHA business model.

### Establish a Housing Market Utility

The relationship between FHA and the Government National Mortgage Association (GNMA) is a model that could work well in a post-GSE environment. Again, with a broad view of the secondary market at-large, GNMA could become an effective housing finance market utility that serves several key operational functions. First, its securitization platform could become universal to all issuers over time with some modifications, thereby providing consistency and transparency to investors. The FHFA has undertaken an initiative to develop a new securitization platform for the GSEs and such efforts ought to be coordinated with GNMA closely. Second, the evolution of GNMA to a market utility should include its role in developing effective pooling and servicing agreements (PSAs) for securities other than GNMA. Third, the utility should become the repository for the National Mortgage Database currently under development by the FHFA and CFPB. Such a database would provide regulators, FHA and other key stakeholders with the information needed to make adjustments to countercyclical policies, credit and collateral policy, and pricing of federal guarantees, among other far-reaching benefits for the industry.

### **Concluding Remarks**

Without question FHA is an essential part of the housing finance system. While maligned for the current financial challenges of the MMIF, it is important to keep in mind that FHA has served this country well for nearly 80 years. However, like many institutions, FHA has not kept pace with important structural changes in its market. The advent of securitization and other sophisticated capital markets risk transfer mechanisms have left FHA at a competitive disadvantage vis a vis other market participants. The lack of a clearly defined mission for FHA along with potential conflict between its social and financial missions are major contributing factors to the current state of the MMIF. The agency requires a number of major reforms in order to put it on a secure financial footing that will ensure its important legacy for borrowers for the next 80 years.