FY09 FHA ACTUARIAL REPORT

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

DECEMBER 2, 2009

Printed for the use of the Committee on Financial Services

Serial No. 111–91

U.S. GOVERNMENT PRINTING OFFICE

56–234 PDF WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

HOUSE COMMITTEE ON FINANCIAL SERVICES

BARNEY FRANK, Massachusetts, *Chairman*

PAUL E. KANJORSKI, Pennsylvania
MAXINE WATERS, California
CAROLYN B. MALONEY, New York
LUIS V. GUTIERREZ, Illinois
NYDIA M. VELÁZQUEZ, New York
MELVIN L. WATT, North Carolina
GARY L. ACKERMAN, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
DENNIS MOORE, Kansas
MICHAEL E. CAPUANO, Massachusetts
RUBÉN HINOJOSA, Texas
WM. LACY CLAY, Missouri
CAROLYN MCCARTHY, New York
JOE BACA, California
STEPHEN F. LYNCH, Massachusetts
BRAD MILLER, North Carolina
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
MELISSA L. BEAN, Illinois
GWEN MOORE, Wisconsin
PAUL W. HODES, New Hampshire
KEITH ELLISON, Minnesota
RON KLEIN, Florida
CHARLES A. WILSON, Ohio
ED PERLMUTTER, Colorado
JOE DONNELLY, Indiana
BILL FOSTER, Illinois
ANDRÉ CARSON, Indiana
JACKIE SPEIER, California
TRAVIS CHILDERS, Mississippi
WALT MINNICK, Idaho
JOHN ADLER, New Jersey
MARY JO KILROY, Ohio
STEVE DRIEHAUS, Ohio
SUZANNE KOSMAS, Florida
ALAN GRAYSON, Florida
JIM HIMES, Connecticut
GARY PETERS, Michigan
DAN MAFFEI, New York

SPENCER BACHUS, Alabama
MICHAEL N. CASTLE, Delaware
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
RON PAUL, Texas
DONALD A. MANZULLO, Illinois
WALTER B. JONES, JR., North Carolina
JUDY BIGGERT, Illinois
GARY G. MILLER, California
SHELLEY MOORE CAPITO, West Virginia
JEB HENSARLING, Texas
SCOTT GARRETT, New Jersey
J. GRESHAM BARRETT, South Carolina
JIM GERLACH, Pennsylvania
RANDY NEUGEBAUER, Texas
TOM PRICE, Georgia
PATRICK T. MCHENRY, North Carolina
JOHN CAMPBELL, California
ADAM PUTNAM, Florida
MICHELE BACHMANN, Minnesota
KENNY MARCHANT, Texas
THADDEUS G. McCOTTER, Michigan
KEVIN McCARTHY, California
BILL POSEY, Florida
LYNN JENKINS, Kansas
CHRISTOPHER LEE, New York
ERIK PAULSEN, Minnesota
LEONARD LANCE, New Jersey

JEANNE M. ROSLANOWICK, *Staff Director and Chief Counsel*

CONTENTS

FY09 FHA ACTUARIAL REPORT

Wednesday, December 2, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 1 p.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Waters, Watt, Sherman, Moore of Kansas, McCarthy of New York, Lynch, Green, Adler, Himes, Peters; Bachus, Miller of California, Capito, Hensarling, Garrett, Neugebauer, Posey, and Jenkins.

The CHAIRMAN. The hearing will come to order.

Today's hearing has been called to look into the status of the FHA. We are pleased to have the Secretary of HUD, Secretary Donovan, and we appreciate his accommodating us. We have changed the schedule a couple of times, and I thank him for doing that. And then we had some votes. But we will, I think, be able to get through the votes and to question the Secretary so he will be able to leave on time. And he is accompanied by Commissioner Stevens of the FHA.

Because we are delayed, I am not going to take a lot of time in my opening statement, just to say that I think there is a common interest in having an FHA that is financially sound and socially useful. And this is a collaborative effort to improve it.

This committee, during this period between the election and the assumption of office of the new Administration, had a hearing with FHA officials, and out of that, in fact, came some legislation that we adopted to increase the ability of the FHA to deal with problems.

This committee has adopted legislation as well that banned seller-financed downpayments. Some members thought it went too far, but at the very least, it gave them that tool. We also gave them debarment authority, which they didn't previously have.

Obviously, no one can expect, in an agency dealing with housing, to be totally free of problems in this area of housing, given where we are today. And we are talking about a new Administration, and we are talking about some problems which they inherited.

And the question we have now is: What can we do going forward to fully strengthen the hands of the Commission or the Secretary so that they can, as I said, have this agency perform its very important social and economic mission in a fiscally responsible way.

And this being a hearing with the Secretary, we have two 5-minute statements and two 3-minute statements. I now recognize the gentleman from Alabama for his statement.

Mr. BACHUS. Thank you, Mr. Chairman, for granting the request that Housing Subcommittee Ranking Member Capito and I made last month to hold a hearing on the FHA's recently released actuarial report.

I would also like to welcome Secretary Donovan. I had the opportunity to observe Secretary Donovan on a trip to Alabama, and I was most impressed, and I believe that you are doing a good job at the FHA.

In the interest of time, I am just going to read my statement.

The deteriorating financial position of the FHA's Capital Reserve Fund has raised concerns that, like Fannie Mae and Freddie Mac, the FHA may soon require its own taxpayer bailout.

Along with Oversight Committee Ranking Member Issa, I sent a letter to Secretary Donovan on November 2nd requesting detailed information on the FHA's business practices, including how the agency is working to prevent a taxpayer bailout. And again, I would like to thank the Secretary for his cooperation in gathering that information.

The findings of the actuarial report released on November 6th reveal that FHA's Capital Reserve ratio had dropped below the congressionally-mandated threshold of 2 percent to a less than expected .053 percent. The independent actuarial review also indicated that the economic value of the Mutual Mortgage Insurance Fund declined over 75 percent from last year to $2.73 billion. If home prices do not recover, the economic value of the fund could drop below zero, which could in turn prompt HUD to request an appropriation from Congress.

Mr. Chairman, I am encouraged by the announcements that Secretary Donovan and Commissioner Stevens—and I am glad that you have joined us to answer questions—have made regarding the implementation of reforms to shore-up the FHA's reserves and reduce risk, including the hiring of a chief risk officer. But unanswered questions remain.

Fraud continues to plague the FHA program, and I continue to be concerned that the agency lacks the technology and management capacity to perform proper oversight. What steps has the agency taken to improve technology and to adequately attract new staff to manage the growing FHA program? I know there are great challenges there. And what exactly is the agency doing to prevent unscrupulous lenders from dumping risky loans into the FHA portfolio?

Secretary Donovan, I would also like to know what steps the FHA is taking to limit taxpayer exposure to a potential FHA bailout. As the private mortgage market falters, lenders flock to the FHA program, drawn by the 100 percent government guarantee.

Some policy analysts have suggested FHA impose credit risk retention requirements for its originators. Others have suggested FHA provide less than 100 percent insurance coverage on loans. Some members of this committee have recommended that FHA increase premiums and the downpayment requirement. The gentleman from New Jersey, Mr. Garrett, has introduced legislation to raise the minimum FHA downpayment from 3.5 to 5 percent. I would like to know if the FHA is considering implementing any of these measures.

In closing, Mr. Chairman, the FHA's insured mortgages provide millions of low- and moderate-income Americans, as well as first-time home buyers, the opportunity to own a home. This committee must continue to provide effective oversight of FHA to ensure the program will remain viable for years to come.

As the housing market recovers, Congress must also see to it that the agency does not displace the private mortgage market, and that FHA's central mission is not undermined by the expansion to more high-cost areas.

Secretary Donovan and Commissioner Stevens, I look forward to your testimony and answers to questions, and promise you my cooperation in working with you on these critically important issues. I know it is not something you caused, it is something you inherited, and I promise you my cooperation. I yield back the balance of my time.

The CHAIRMAN. The gentlewoman from West Virginia for 3 minutes.

Mrs. CAPITO. Thank you, Mr. Chairman. Thank you for holding this important hearing this afternoon on the financial health of FHA. As has been said, the ranking member and I wrote a letter to the chairman about the importance of having this hearing, and I appreciate him accommodating our request.

On November 6, 2009, we received the annual independent actuarial review of the FHA's Mutual Mortgage Insurance Fund. We had been warned by the Commissioner that it was going to fall below the congressionally-mandated ratio of 2 percent. The report says that it has fallen well below that level, and it now stands at .53 percent.

As we are all aware, FHA has reemerged as a major market participant, insuring almost 30 percent of home purchases and 20 percent of refinances. FHA has a critical role to play in our housing market, and if it is going to maintain this level of participation, we must work together to ensure that the program remains self-sustaining and returns to a solid financial footing.

I am encouraged by many of the steps that Secretary Donovan and Commissioner Stevens have taken so far to shore-up the FHA. But there is more to be done. I think we could agree on that. I look forward to a vibrant discussion on whether or not FHA has the resources to upgrade technology, and also compete for experienced personnel to streamline their operations and improve efficiencies.

Secretary Donovan mentions in his testimony that FHA may be exploring raising premiums for new borrowers. In late 2007, FHA issued regulations to implement a risk-based pricing program, but Congress put a year-long moratorium on that, which essentially ran through October 31, 2009.

One of my questions will be: Does HUD intend to implement a risk-based pricing program once the moratorium is expired, which it has? And if the need to raise premiums on all borrowers is clear, why should we not have FHA price their premiums based on risk?

I would also like to hear more from the Secretary on stories of FHA borrowers who are not able to make that first payment. I understand that is becoming a bit of a problem. It would be helpful to know the statistics on first payment default rates, and I know that the Secretary is indicating that he will be seeking greater recourse with lenders, and I look forward to hearing more details on that.

I want to welcome Secretary Donovan back to the committee today. The FHA program is an important component to the housing market. Congress and HUD need to do everything that is necessary to make sure this program is run in a manner that does not expose the taxpayer to yet another bailout. I look forward to hearing from you, and I want to thank, again, the chairman for having this hearing. Thank you.

The CHAIRMAN. Mr. Secretary?

STATEMENT OF THE HONORABLE SHAUN DONOVAN, SECRETARY, U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ACCOMPANIED BY THE HONORABLE DAVID STEVENS, ASSISTANT SECRETARY FOR HOUSING/FHA COMMISSIONER

Secretary DONOVAN. Thank you, Chairman Frank, and Ranking Member Bachus, for this opportunity to testify on behalf of the Administration regarding the Federal Housing Administration and the steps we are taking to protect its loan portfolio as it helps to get the economy back on track at this historic moment.

We want to ensure that we are able to continue to support the housing market in the short term and provide access to homeownership over the long term while minimizing the risk to the American taxpayer. Created by President Franklin Roosevelt at a time when 2 million construction workers were out of work and housing prices had collapsed, the FHA was designed to provide affordable homeownership options to underserved American families and keep our mortgage markets afloat during tough times.

And by insuring almost 30 percent of purchases and 20 percent of refinances in the housing market, FHA is certainly doing so today, though I would caution that we are by no means out of the woods. As the National Association of Realtors reported last week, home sales have rebounded to levels not seen since February 2007. And the S&P Case-Shiller Home Price Indices find that home prices have now risen for 2 quarters in a row.

While there is considerable uncertainty about what these numbers mean going forward, what is not in doubt is that the FHA has been central to much of this improvement. We know the critical role first-time home buyers are playing in the market. More than three-quarters of FHA's purchase loan borrowers in 2009 are first-time home buyers, and nearly half of first-time buyers in the housing market in the second quarter used FHA loans.

Unfortunately, FHA has not been immune to the hard times for the housing sector. With the actuarial study I cited earlier, we recently reported to Congress that FHA's secondary reserves have fallen below the required 2 percent level, to .53 percent of the total insurance in force.

However, when combined with reserves held in the financing account, FHA holds more than 4.5 percent of total insurance in force in reserves today. Indeed, with $31 billion set aside specifically to cover losses over the next 30 years, the actuary concluded that FHA's reserves will remain positive under all but the most severe economic scenarios.

Further, while its secondary reserve account has been significantly depleted, FHA is not the next subprime, as some have suggested. Subprime delinquencies are 240 percent higher than FHA's, for a reason. FHA stuck to the basics during the housing boom, 30-year fixed-rate traditional loan products with standard underwriting requirements. Unlike some prime lenders, FHA requires that borrowers demonstrate they can pay their mortgage by verifying their income and employment.

Still, we have learned from recent history that the market is fragile, and we have to plan for the unexpected. That uncertainty is complicated by an organization we inherited that, to be honest, was not properly managing or monitoring its risk. Credit and risk controls were antiquated, enforcement was weak, and our resources and IT systems were inadequate.

Little of this may have been obvious when FHA's market share was 3 percent as recently as 2006. But when our mortgage markets collapsed last fall, and home buyers increasingly turned to the FHA for help, the potential consequences of these lapses in risk management became clear.

In 2008, Congress put an end to the practices that led to the most troubled loans in FHA's portfolio, so-called seller-financed downpayment assistance loans. This year, we have taken several additional steps, many of which we announced on September 18th. We have steeply increased enforcement efforts, having suspended 7 lenders and withdrawn FHA approval for 270 others, including Lend America just this week.

We have strengthened credit and risk controls, toughening requirements on our streamlined refinance program, making several improvements to the appraisal process, and proposing a rule to increase net worth requirements for all FHA lenders. And we have hired a permanent chief risk officer to provide the most comprehensive and thorough risk assessment in the organization's history, and delivered FHA's first comprehensive technology transformation plan to Congress in September.

As significant as these reforms are, Mr. Chairman, as Senator Bond recently wrote in the Washington Post, these management and resource challenges are longstanding challenges that should have been addressed a long time ago. That is why we are drafting several new policies in FHA to address the quality of the existing portfolio, improve the performance of future books, and return the capital reserve to above the legislated 2 percent level, while also ensuring that FHA continues to contribute to the Nation's housing recovery.

The actuary projects that even with growing volumes, more than 71 percent of FHA's losses over the next 5 years will come from loans already on our existing books. That is why an important step we can take to minimize losses to Capital Reserves in the near term is to increase enforcement and make lenders more accountable.

As such, we will step up efforts to ensure lenders assume responsibility for any losses associated with loans not underwritten to

FHA standards. We will hold lenders accountable for their origination quality and compliance with FHA policies, increasing our review of mortgagee compliance with FHA program requirements.

And we intend to expand enforcement of new loans as well. That includes requiring lenders to indemnify the FHA fund for their own failures to meet FHA requirements, and holding lenders accountable nationally for any improper activities, as we are presently limited to sanctioning individual branches. We will also develop a lender scorecard posted on our Web site that will summarize the performance of lenders who do business with FHA.

In addition to stepping up enforcement and accountability, which will improve the performance of both the existing and future books of business, we are committed to making additional steps to increase the quality of our business going forward.

First, an initial measure is to reduce the maximum permissible seller concession from its current 6 percent level to 3 percent, which is in line with industry norms. And we will continue to consider additional reductions.

Second, to protect the fund from the riskiest loans, we will for the time being also raise the minimum FICO score for new FHA borrowers. We are currently analyzing what this floor should be, including the relationship between FICO scores and downpayments, to determine whether we should increase FICO minimums in combination with changes to other underwriting criteria for lower downpayment loans.

Third, we have made the decision to exercise our authority to increase the up-front cash that a borrower has to bring to the table in an FHA-backed loan, to make sure that FHA borrowers have more skin in the game and a stronger equity position in their loans.

Finally, we are examining our mortgage insurance premium structure to determine whether an increase is needed, and if so, whether it should be the up-front premium, the annual premium, or both. To protect against future uncertainty in market conditions, we are requesting authority from Congress to raise annual premiums, as this is one of the most effective means of raising capital for the fund with the least impact per borrower.

Indeed, while most of these changes I have just described we can make on our own with no additional authority, and we expect to provide detailed and public guidance for these changes by the end of January, in some cases, we will need Congress' help.

In addition to asking Congress to increase the current cap on the annual mortgage insurance premium for new borrowers, we are asking for additional authority for our proposals to hold all FHA lenders responsible for their fraud or misrepresentations by indemnifying the FHA fund.

We will also be asking Congress to expand FHA's ability to hold lenders accountable nationally for their performance, as I mentioned earlier. Each will require statutory support, and of course we look forward to working with Congress closely on all these issues.

Mr. Chairman, Ranking Member Bachus, shoring-up the FHA won't solve all our housing challenges, which is one reason the Administration is working to produce a more balanced, comprehensive national housing policy that supports homeownership and rental housing alike, providing people with the options they need to make good choices for their families.

Further, as important as the FHA is at this moment, I want to emphasize that the elevated role it is playing is temporary, a bridge to economic recovery, helping to ensure that mortgage finance remains available until privilege capital returns.

That means that while we must remain mindful that qualified, responsible families need the continued ability to purchase a home, the changes I have announced today and will detail in the coming weeks will be crafted to ensure FHA steps back, and will facilitate the return of the private sector as soon as possible.

But the bottom line is this: While FHA must remain a key source of safe mortgage financing at a critical moment in our country's history, we recognize the risks that we face and the challenges of this temporary role that we play in today's market. And the bottom line is this: The loans FHA insures must be safe and self-sustaining for the taxpayer over the long term. With these reforms and others we will be considering, the Administration is committed to ensuring that they are today and into the future.

Thank you very much.

[The prepared statement of Secretary Donovan can be found on page 51 of the appendix.]

The CHAIRMAN. Thank you, Mr. Secretary. We will obviously consider your request for the premium increase. I am reminded by staff that the Congress did give an increase in the up-front premium in the recent legislation. And the House had proposed a small increase—not as much as President Bush asked for, in the annual fee, and the Senate objected. So there was no increase in the annual fee. But we are certainly open to that.

Let me just say, with regard to fees and risk-based, I agree that we should do that. But I have this one concern: I don't want a situation in which a woman making $50,000 a year and working very hard and getting a loan and paying it off has to pay a higher premium at the end than somebody making 3 times that amount of money because she was in the risk-based category.

That is, I want to do risk-based, but there has to be some way that those people who are in what is considered a risky category, who make their payments, get some compensation because otherwise, you have the situation in which we make people in lower-income brackets or lower-middle-income brackets the insurers of each other, while those of us who are wealthier don't have to bear that.

If there is going to be some cross-subsidy, I mean, a risk-based premium is a form of cross-subsidy. It is taking the overwhelming majority who pay off and making them put in a little extra to take care of those who don't pay off. I am for that principle, but it can't be done on an income basis.

I had raised this issue with Mr. Stevens' predecessor, Mr. Montgomery, and he said, well, they didn't find a correlation between income level and risk level. If that is the case, I may feel better.

But it does seem to me that there needs to be some care taken here to make sure we are all talking about wanting to expand homeownership, not to people who can't afford it. We have made that mistake in the past. But working people at lower incomes who are still eligible who conscientiously make their payments shouldn't have to pay extra, and I would look to that.

The other issue I want to address is the astonishing misinformation that appears to have taken over so many journalists about the higher-cost loans. It frankly began with an article in the New York Times, and the Washington Post picked it up.

If you read the articles, they appear to believe that what we did was to set—the gentleman from California, Mr. Miller, is here—a national limit of $729,000 on loans. In fact, the operative limit on FHA loans in the country is not that dollar number but the median house price. The FHA lends according to the median house price.

Now, house prices are the most geographically, not surprisingly, varying price in America. And we have agreed that you should not have the FHA paying for luxury housing, guaranteeing luxury housing. A limit was set of $417,000 a few years ago.

That meant that there could be no luxury housing in Nebraska, as I look at the numbers, or in Alabama, or in much of Michigan. It meant there could be no luxury housing in northern California or in Massachusetts and in New York City. It also meant that there couldn't be any middle-income housing in those latter categories. That is, when you say the median, but then you cut it off at $417,000, you effectively say that the program can't work in certain States.

Indeed, the Times article said, well, they used to not make any loans in California and now they are making them. Yes, that is what we wanted to do. We didn't think it was fair for California to be frozen out of a program which is supported as much by California taxes as any other. So what we have said is, we will continue to say that the FHA should lend to the median and below. But if you set too unrealistically low a price, many areas of the country will not get the benefit of the FHA.

Now, even with that, the average amount is still much lower than that. The journalists have been talking about $729,000. One article, again in the New York Times, said, well, everybody ought to be able to get this, somebody said, and the reporter said, everybody can. Yes, if she lives in San Francisco or in 50-some-odd other counties. But there is only a small number of counties in the country that have that. In 23 States, the increase made no impact at all.

Finally, I would note that according to the auditor of the FHA and the CBO, going to the genuine median in those other parts of the country that are above $417,000 and still hit the median house price are not any more risky than other loans. The CBO gives you a zero negative score. There is no cost to the FHA from allowing the program to be operative in northern California or southern California or Massachusetts, as opposed to saying it can't operate there at all. The auditor says that those things are pretty safe.

The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman.

Secretary Donovan, I have read your written testimony, and I am very impressed with your game plan, the things that you are addressing. And I want to compliment you. Obviously, I think enforcement is essential. We pass all the regulations, but without enforcement, they mean little.

Holding lenders accountable is critical. And improving the quality and sustainability of new loans, you have outlined that, and increasing FHA capital. So I commend you and Commissioner Stevens. I have been impressed with your knowledge of the markets. You understand the markets. So I am optimistic that there are going to be changes made for the better. And there already have been, so I compliment you on that.

One of the things you mentioned in your testimony was asking Congress to raise the cap on annual premiums is under consideration. What level do you think would be appropriate for an annual premium? Have you given that any consideration?

HUD already has the authority to increase the up-front premium up to 3 percent. I would be interested to hear any testimony that either one of you would like—or any response that you would like to give, why you think the increase in the annual premium is necessary.

Secretary DONOVAN. There are two things I would say. One is, as I mentioned in my testimony, we are still looking at precisely the balance of pricing that is necessary. And perhaps it goes without saying, but to be clear, the balance we are trying to strike is ensuring that the early signs of housing recovery that we have seen continue.

And the concern would be that if we overprice, we have the potential to hurt ourselves as well as the broader economy in doing so, by making capital more expensive in a way that would hurt the market. So we are looking carefully at that balance.

However, one of the things that has become clear, the annual premium is, as you say, at the statutory maximum at this moment. And our analysis shows that the annual premium can be a more effective way to increase the balance of the reserves within the fund over the long term with the least impact on the market.

And that is why we think it is important, not that—I am not announcing today that we have made a decision to increase those annual premiums. But we would like—today we couldn't if we wanted to because we don't have that authority. So that is quite important.

We have not made any determination about what increased level we would want Congress to raise it to. I think certainly providing as much flexibility as possible, but I would say we would like to work with you to determine what level you might be comfortable with above the current level of .55 percent that we do charge for most loans.

Mr. BACHUS. Okay. And Commissioner Stevens, I don't know if you have any other comments you would like to make?

Mr. STEVENS. I would relate it back to the thoughts about risk-based pricing. If you think about a risk-based pricing grid, you can only do so much with up-front premium because that would hit its cap fairly early on. And when you have the annual capped at .55 where it is today, a risk-based pricing program could actually worsen the capital for FHA over time trying to build up the capital reserves if you can't address the annual.

So that flexibility needs to absolutely be there to be able to trade those two off together to come up with a program that works best for the market.

Mr. BACHUS. Right. I understand we are caught in a situation where the markets are in distress. And that is a delicate balancing act. I do acknowledge that.

I would like to yield the balance of my time to Ms. Capito.

Mrs. CAPITO. Thank you. I would like to thank the ranking member. I will just jump right in with a couple of questions.

Mr. Secretary, in my opening statement, I spoke about the risk-based pricing, that the moratorium was supposed to end on October 31, 2009. And obviously, we are beyond that date. Are you implementing that, or what is your plan? Are you looking at that? What is HUD's position at this point?

Secretary DONOVAN. There are a couple of comments I would make about risk-based pricing. There is the concern that the chairman raised about it. There is also another concern that I would raise that I think is a very important one. We take very seriously this issue of our increased role in the market being a temporary one. And one of the concerns I have, is if we were to lower pricing for the least risky borrowers, that has the effect of potentially crowding out the return of the private market, or at least delaying it beyond what we might see otherwise.

I think we have to think carefully about risk-based pricing both in terms of whether we are pricing risk correctly for the riskiest borrowers, but also whether we have the effect of stopping the private market from returning as quickly as possible.

One of the things that we are examining is the potential for combining, for example, FICO scores, loan-to-values, and other underwriting criteria in a way that we would limit the entry of the riskiest borrowers into the fund without discouraging private capital; so rather than a form of risk-based pricing, looking at risk-based underwriting, if you will, and adjusting our standards, adjusting loan-to-value and other criteria.

Because ultimately, what we find, and we would be happy to share more detailed data with you, is that there is no single characteristic—loan-to-value, FICO score—that is a good predictor of performance. It is the combination of those that really has the effect.

The second thing I would say is that it is important to remember—something I said in my testimony which I think bears repeating: 71 percent of our projected losses in the actuarial study come from loans that are already on the books, and even though our loan volumes were very, very low over the last few years, what had been the most troubled loans.

So in fact, I also think we have to be careful of, in some ways, overcharging. The actuarial study said our loans that we are making today are quite profitable under just about any potential scenario. I think we have to be careful about overpricing risk in a situation where what we really have is something that can be solved by greater enforcement and some of the other backward-looking steps that we are talking about. So that is a very important balance.

In sum, I think what you will see is when we announce the final details of the changes I talked about today is that we will have some risk-based criteria that we apply, but it won't clearly be the risk-based pricing. That is one option. But it is quite possible that it might be focused on other ways of underwriting risk and varying our underwriting, depending on the risk criteria.

Mr. MOORE OF KANSAS. [presiding] Thank you. The Chair recognizes himself for 5 minutes.

Mr. Secretary, does FHA have the tools it needs to manage its growing portfolio? Your market share has gone from 3 to 30 percent, yet you essentially have the same amount of staff and the same computer systems that you have had. This is what we heard from HUD's Inspector General in an Oversight and Investigations Subcommittee hearing that I chaired earlier this year.

Is Congress doing enough to get you the resources you need right away? Would you like for FHA to have the ability to use some of the premiums it collects to upgrade staffing and technology, as is the practice at every private sector firm?

Secretary DONOVAN. First of all, I want to thank Congress for a number of steps that you have taken this year that have been very, very helpful to us. We were provided in our last appropriations bill with funding to develop the very first comprehensive technology plan for FHA. We delivered that plan in September, and we are moving forward on implementing that plan.

Based on our latest discussions about the 2010 appropriations with both the House and the Senate, we do believe that we will have adequate funding to get that plan under way in terms of technology. It also provides, along with appropriations from this year, the ability for increased staffing at FHA, although I think we do need to go farther on that front.

I will turn to Commissioner Stevens for any more detail he may want to provide on the number of new heads we have brought on board and what the future plans are. But clearly, staffing is an issue that we continue to focus on.

Mr. STEVENS. Thank you. We can talk about what we have brought on. We have certainly added to staff. Under our risk management area, not only have we brought on a chief risk officer, we brought in seven new individuals in our evaluations group, five of whom are Ph.D. economists to help us better evaluate the portfolio.

I would refer back to the Secretary's comments that we clearly need an increase in personnel. There is an allocation for that in the appropriation. And once that is passed, we will begin to be able to add new resources.

I would just add the one point that many of the changes we are announcing here today really don't require any additional staffing. They are purely logical moves to control risk that aren't dependent upon new technologies to implement.

And so to that extent, I think we can actually protect much of the risk coming into the portfolio and improve the returns without this immediate up-front increase in staffing. However, that is absolutely needed over time.

Mr. MOORE OF KANSAS. Thank you.

Mr. Secretary, the previous leadership at HUD and FHA promulgated rules to ban seller-funded downpayment assistance, and Congress under HERA statutorily banned this practice. The actuarial report found these loans to be the leading cause of why FHA is on the brink of insolvency, and said that without them, FHA's reserves would be above the statutory minimum of 2 percent.

What are your views on this seller-funded downpayment assistance practice, and would you support efforts to circumvent FHA's minimum downpayment requirement?

Secretary DONOVAN. As you rightly said, one of the things that the actuarial report made crystal clear is that—

Mr. MOORE OF KANSAS. Thanks for saying that right.

Secretary DONOVAN. Don't ask me to say it again, though—is that without those loans, we would have been above the 2 percent congressionally-required minimum. They have had a significant drain on our portfolio, roughly a loss going forward beyond existing losses we have already taken of about $10 billion, just on that portfolio. So I do think Congress took the right step.

We are very focused not only on ensuring that the 3½ percent downpayment remains, but in fact, as I said today, finding ways to increase the cash up-front that needs to come in on FHA loans. And I would also point out that there are a number of ways to do that.

Downpayment is one of them. We have an up-front premium; how that is treated is important. Seller concessions is another way that we can ensure that there is a minimum of cash up-front. So there is a range of steps that we can take. And we are looking at the broad group of those.

But I also think it is important, as I stated just a moment ago, that we make sure we understand the combination of risk factors that are there. In fact, we have loans that have a 3½ percent downpayment that perform extremely well where you have high FICO scores or other high-quality indicators in the underwriting.

So I think we need to take a nuanced approach in terms of really isolating those loans that are the riskiest based on multiple factors, while at the same time ensuring that we continue to make homeownership available for those who can be successful homeowners. And I think that is exactly the approach that we are trying to take.

Mr. MOORE OF KANSAS. Thank you, sir. My time is expired. And the Chair next recognizes the gentlelady from West Virginia.

Mrs. CAPITO. Thank you.

Mr. Secretary, let me ask you—well, let me just make a quick comment. You know, in light of the fact that the Commissioner, when we heard about the pre-report of the audit, said that he thought it was going to go below the 2 percent, and then I think the audit showed that it is significantly below the 2 percent, maybe more than what was originally anticipated, that I might make a suggestion.

And I think our next panel might have made the suggestion in their comments as well, that we don't wait another whole year before we do another audit, that we maybe do a flash audit or something in a 6-month period of time so we can see what direction we are going so that we don't keep falling down a cliff here.

So I offer that as a suggestion. I think it would be a smart thing to do. And if you have a comment on that, that would be fine.

The other question I had was in your comment—and you were just alluding to this; you were talking about more skin in the game for the borrower, talking about maybe premiums or downpayment—I read a scenario in our briefing materials where some people who could possibly take the first-time home buyer credit could borrow the money, get the money back off the credit, and then actually that $8,000 could actually cover what would have been their downpayment. And there they are back into basically not really, you know, feeling it maybe as much as a lot of other people who have a full—who don't have access to that or try to make a downpayment.

Is that the kind of thing you are talking about here, the skin in the game? And I am going to tie that in to one of the other questions I had in the beginning, which is: Has there been an increase in the number of people who are not making that first-time payment? I mentioned it. Is that a problem? How do you monitor that? And what are you doing with the lenders that go forward with those loans?

Secretary DONOVAN. On this question, first of all, the audit, let me say right up-front—and we probably have a few bleary-eyed people sitting behind me, and Commissioner Stevens—rest assured that we have been in constant touch with the actuary, have been using those models, and we will be running scenarios.

One of the reasons why it was so important—and Dave brought on a very, very high-quality, experienced person as our chief risk officer—we want to know almost daily what is happening with the portfolio. We haven't had the tools to do that in the past, and we are now constantly re-looking at scenarios based on the latest economic data: where home prices are going, where sales volumes are going, and on a realtime basis updating our view of the fund.

So I think even—

Mrs. CAPITO. We would probably appreciate maybe a little bit of a midterm kind of—

Secretary DONOVAN. Absolutely. In fact, we do now a 6-month reestimate under the fund. We would be happy to make that more publicly available. But we would also be very open to coming and sitting down more regularly with the committee, sharing information.

Mrs. CAPITO. Okay. Thank you.

Secretary DONOVAN. Rest assured, we will be looking at that data on a very, very frequent basis.

Second of all, on this issue of the first-time buyer tax credit, I am glad you raised this because I think there is some confusion about this. We made a very clear policy which we felt was important, in fact, not just for FHA loans, but to set a standard in the market, is that the credit itself could not be used towards the 3½ percent downpayment. It could be used for downpayment above and beyond it. It could be used for other costs, like closing or others. But we had a clear policy that it could not be used to pay for the 3½ percent downpayment.

In addition to that, there is the risk that you talk about where somebody might go and borrow that money, unbeknownst to FHA, and pretend that it was cash that they had in-house. One of the important things that Congress did in extending the credit was to institute a range of fraud protection measures, and we have also put into our system ways to flag the use of the credit so that we can go back and check and make sure that we do oversight to ensure that practice is in fact not happening.

So we have put in place a number of steps to do that. But I want to just clarify that we have a very clear policy that you cannot use the $8,000 credit, or now even the $6,500 credit, towards that 3½ percent downpayment.

Finally, just on the first-payment defaults, I think consistent with the broader improvement in the quality of our portfolio that we have seen over the last year, the statistics have declined substantially in terms of those first-payment defaults. They have been cut more than in half over the last roughly year-and-a-half, almost 2 years. So we have seen significant improvement there.

Mrs. CAPITO. Thank you.

Mr. MOORE OF KANSAS. The Chair next recognizes the gentlewoman from New York, Ms. McCarthy.

Mrs. MCCARTHY OF NEW YORK. Thank you. And I appreciate, Secretary Donovan, what you have been doing. A number of things that you had talked about, and I just want to kind of go back on them.

When I see the TV advertisements on these loans—no credit checks, nothing—and I know that you had already mentioned in your testimony and speaking today about how that you are cracking down on these predatory lenders, I think that it would be interesting—because, actually, people do watch these hearings—if you could go in a little bit deeper on how you are actually finding these predatory lenders from the false advertising, which I think they are doing an awful lot of on TV, how you are actually looking at the new standards that you have put in place to make sure that they are not in the FHA system.

The second part is, which is a little off to the side but it is a great concern to me, with everything going on, do you see in the future that you are going to be able to actually do a little bit more improvements on the Section 8 housing? I can say for Long Island that we have almost—certainly we don't have anywhere near the kind of housing that we need.

On Monday, I visited with a constituent who is in a Section 8 apartment, if you want to call it that. This is unfortunately someone who is very ill. It is someone who basically has some neurological muscular problems. And they keep putting him on the second and third floor walk-up, which means that to get him out to go to the doctors and everything else, it has really become difficult for these particular constituents and patients. In my former life, I was a nurse before I got here.

We are looking at how we are going to have more Section 8 housing for those with disabilities, which I think is important. Thank you.

Secretary DONOVAN. Thank you. To start with, on this question of fraud, I will turn it over to Commissioner Stevens to talk a little bit more in detail about what we are doing within FHA. But let me just mention that one of the most important things we can do, because many of these lenders are not FHA lenders or they have other types of loan products besides FHA, one of the things that we do is participate very closely in a fraud task force that has been led by Attorney General Holder.

And what we have seen is Chairman Leibowitz at the Trade Commission has been very, very aggressive, as well as our own Inspector General, as well as the Department of Justice, in stepping up enforcement efforts against those lenders. Oftentimes, we don't need any violation within FHA to go after them for false advertising for a range of other problems that we see.

We also have been coordinating very closely with the State attorneys general to crack down through their enforcement powers as well. I would be happy to get you some briefing material or more about what we are doing there. And if you have particular lenders that you are concerned about, we may have a multitude of options in terms of the ways that we go after them through that task force.

Mr. STEVENS. Just to highlight the focus on this particular area, it has been paramount in our new Administration to focus on fraudulent lenders. I am looking here at a narrow report that we now review monthly on lender compliance. We scrutinize institution by institution based on a variety of performance characteristics.

And we take action—in fact, the Secretary referred to seven institutions. We have already terminated their approvals this year. That doesn't include a number of them which we just did yesterday, in our significantly stepped-up meeting schedule in the Mortgagee Review Board where we take action.

I am also working very closely with the Inspector General at HUD to increase enforcement and investigations into institutions. And we actively encourage everybody in the industry to please send us examples of violations of marketing so we can go after institutions at an institutional level. I have two examples today alone where we took action against those institutions.

So I think you are raising a most critical element. And this is where we can most effectively ensure that the participants in the FHA system follow the rules that are required to protect the taxpayer and protect the homeowner.

Secretary DONOVAN. I would also just call attention to a point I made in my testimony, that there are authorities we don't currently have that we would like to have, and I want to work with you on the committee to be able to expand our authority.

One of those is that our authority currently is limited in terms of being able to suspend lenders effectively by branch, only in a limited area, not nationwide. One of the things that Dave is doing on a regular basis now is monitoring lenders and scrutinizing them more closely where they have performance claim and default performance that is well above the average, more than double what we see is the average. And yet we need expanded powers to be able to take more aggressive action against some of those lenders. And we look forward to working with you on that.

Just finally, on the Section 8 question, having a balanced housing policy that includes both rental and homeownership is one of, I think, the most important lessons of the crisis that we have seen. It is one of the reasons why, in the President's budget this year, we asked for a $1.8 billion increase for Section 8 voucher funding.

But it is also why, particularly for people with disabilities, a Section 8 voucher may be the perfect solution for them. On the other hand, for many in the disabled community, housing in a Section 811 unit, which is part of a program that is specifically targeted for the disabled may be the solution, or supportive housing, which we have grown our support for also substantially.

And I am very encouraged by the response that we have gotten to the budget in Congress. I look forward to having the 2010 budget completed as soon as possible to be able to use that funding going forward.

The CHAIRMAN. The gentleman from California, Mr. Miller.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

Mr. Secretary, I want to congratulate you on reforms you have made to FHA. I think you are doing a really good job, and I am really glad to see them.

In September, we passed a bill associated with elevatored multifamily buildings. Now, I don't know what the state of the multifamily program is today, if it is in financial trouble or if it is doing well. But we are underserving the buildings that are higher-cost buildings in elevatored areas.

Would you like to comment on that?

Secretary DONOVAN. Sure. First of all, I would just generally say—and I don't know if Dave has any further details he would want to provide—but we are effectively seeing a similar situation in the multifamily portfolio as we are seeing in the single family; in other words, given the retreat of private capital, the lack of private capital, given the undercapitalization of many financial institutions, we have seen a growing importance of FHA in that market.

And as well, we are looking at a range of risk management and other strategies that we have already stepped-up, and additional steps that we are taking in the future. So it is analogous in many ways.

I think on your particular point, similar to the way that, on the single-family side, a temporary increase in the loan limits has been important, similarly, on the multifamily side, we were already effectively shut out of markets in California and in other places. And with the recent retreat of private capital, it has become only more important, I think, that we do increase the loan limits. We are very supportive of that on the multifamily side.

I do want to go back to a point that the chairman raised as well on the single-family side. It is amazing what can get reported, and the idea that just a few loans somehow we are shifting to going upmarket. Let me try and put some facts around what is happening there.

This year, less than 2 percent of our loans have been over $417,000. However, in important markets like California, where there are high-cost needs there and where capital has retreated, we have done a significant amount of loans. But still, even in California, for example, less than 10 percent of all of our loans in the State are above $417,000.

So it is very important to remember—let's look at the facts here. There may be—

Mr. MILLER OF CALIFORNIA. But in California, FHA and GSEs represent 92 percent of the loans. If it weren't for you there, we would have no market at all. And I want to associate myself with the comments the chairman made on the high-cost areas. I think it has done tremendous benefit to this country, and as I understand it, those loans are performing very well.

The CHAIRMAN. Will the gentleman yield?

Mr. MILLER OF CALIFORNIA. I would be happy to, Mr. Chairman.

The CHAIRMAN. Apparently, if you read the press, it is astonishing to note that there are no middle-income people living in California. But the argument was that by raising the loan limits, we are lending in the luxury market. Previously, as some of the journalists have noted, there were no loans made in California. So California has apparently become the first middle-class-free State.

Mr. MILLER OF CALIFORNIA. Well, reclaiming my time, you are doing a very good job representing people who never knew you were there in the past.

You talked about the DPA program. And I totally agree with you. The previous Downpayment Assistance Program was awful. It didn't work. There were too many bad players in the marketplace. And it is sad, because in 2003, one of the large DPA groups wrote HUD, asking them to deal with increased FICO scores, improved appraisals, improving the premiums required, and it went nowhere. They wrote again in 2007.

We met in recent weeks to discuss that issue in Mr. Green's office. And I really want to thank you for that. I think there is a place for the program if it meets your new standards. And the bill that Mr. Green and I were talking to you about, it does a lot of those things. It takes and increases FICO scores for individuals to meet the same standard other FHA borrowers would be. Improves appraisal standards. Increases mortgage premiums.

You have to make sure that these are legitimate charities involved in DPA. You need to make sure that these are absolute gifts that can never be repaid. You have to deal with creditworthy home buyers. You can't just give a payment to anybody who wants the money, and then you are required to go make them a loan to put the taxpayer at risk. We don't want to do that, and we need to require mandatory counseling in these areas.

But I think there is a way that we can say, the old program was awful. How do we look at FHA standards as they apply to everybody, and how do we apply those even a little more stringently to the DPA system we have? Do you have any comments on how that might work in the future?

Secretary DONOVAN. Well, we look forward to discussing it further with you. But fundamentally, I think, the issues that we have seen are that where there is what I would call an interested party in the transaction, there is the potential for that kind of—

Mr. MILLER OF CALIFORNIA. And we have to eliminate that.

Secretary DONOVAN. Right. And—

Mr. MILLER OF CALIFORNIA. I am with you 100 percent on that.

Secretary DONOVAN. So we do allow, for example, families to help a buyer. I certainly, when I bought my first home, help from my family, and that is something that we see broadly.

So I do think that there are ways that downpayment assistance, done in the right way, can be an effective tool. I think the issue has been many of the criteria, but most importantly, that there not be an interested party in the transaction there—

Mr. MILLER OF CALIFORNIA. I am with you 100 percent.

Secretary DONOVAN. —that participates in that. That is where the—

Mr. MILLER OF CALIFORNIA. Thank you. I look forward to working with you on that. Thank you, sir.

The CHAIRMAN. The gentleman from California, Mr. Sherman.

Mr. SHERMAN. Thank you, Mr. Chairman.

News reports have suggested that the higher loan limits in high-cost areas have put a greater risk on the FHA fund. But as I believe the chairman has pointed out, on an actuarial basis, it has actually, as I understand it, added to your reserves.

Mr. Secretary, can you comment on that? And is there a way to quantify the reserve increase that is provided by loans in high-cost areas up to $729,000?

Secretary DONOVAN. What I would say is it is too early, given the relatively recent increase in the loan limits, to make any definitive conclusions about the performance of those loans. We just haven't seen enough seasoning in that portfolio relative to more historical data.

What I will say is that historically, there is some evidence that they do perform, as the chairman said, better than the smaller size loans. So I think it is certainly reasonable to expect that they would, but we don't have definitive data at this point.

But again, I would also emphasize, first of all, that this is a temporary measure, from our point of view. I think we all share an interest that as soon as possible, we step back. And again, only 2 percent of our loans so far this year have been over that $417,000 limit.

So it is very important in specific high-cost markets, and I have data on that. But frankly, it is simply not correct to say that it represents a wholesale shift from where FHA has been.

Mr. SHERMAN. And so it probably has a positive effect, but that effect is very, very small. It is some slight positive or modest positive on 2 percent of your portfolio.

Now, you talk about pulling back. I would point out that the people in my district who are buying a home and borrowing $500,000 or $600,000 are no better off—in fact, they are getting a smaller home—than somebody in Columbus, Ohio, buying a home and borrowing $400,000.

Now, the FHA comprises nearly 40 percent of the mortgage market today. Is this appropriate? And, put another way, what would happen to housing prices if the FHA wasn't a major part of the mortgage market today?

Secretary DONOVAN. I think it is fair to say that if FHA were not active today, that we would not have seen the early signs of recovery that we have. FHA, particularly if you think about our serving nearly half of all the first-time buyers, the fact that in 2008 half of African Americans who bought a home, about 45 percent of Latinos who bought a home, used an FHA loan, it has been absolutely critical, particularly to those buyers who have really made the difference this year in terms of helping to get the market back on recovery.

And I think, most importantly, this is exactly what FHA was created to do. We were created during the Depression to help ensure that mortgage capital was available, on good terms, in a self-sustaining way for the taxpayer, but that it was available during difficult times, and that we step back when the market returned.

Mr. SHERMAN. I would point out that this near deposition was triggered as much as anything by a rapid decline in home prices. And I want to thank you for what your agency has done to stabilize home prices in many parts of the country; had you not acted and had you not had that result, I think we would be dealing with a much, much worse recession than the terrible recession we have now.

What do you think the FHA should do to increase its reserves?

Secretary DONOVAN. I will ask Commissioner Stevens to provide some more thoughts. But certainly the three key areas that I outlined in the testimony—stepping up enforcement on existing loans, given that they represent such a large share of expected future losses; and that has no impact on borrowers going forward, that is a key strategy for us to help ensure the reserves stay as close as possible to where they are, and increase going forward.

Second of all, that we can step up the share of cash that is brought up-front in a transaction; and, third, to look at our pricing through our premium structure.

Mr. STEVENS. The one thing I would continue to draw attention to is the comment the Secretary made earlier, which is that 70 percent of the losses that are impacting our capital are on the existing book of business. And my greatest concern in the existing book of business is whether the loans that were originated by the institutions that insured those under the FHA program originated those within our guidelines.

And that is why the Secretary emphasized the need for us to be able to enhance our ability to go after institutions that originated outside the rules. If we can make institutions pay for those losses instead of FHA picking up that burden, we affect that 70 percent.

The actuary predicts that the future books are actually going to be profitable, assuming their scenario. So what we have to be protective of going forward, outside of institutional control, is to make sure we do enough adjustments in the program to cover a worse scenario than the actuary predicted.

Mr. SHERMAN. Thank you. And with the indulgence of the chairwoman, I would point out that in my own State, where you buy a home for $200,000, the central valley, that is where you have all the foreclosures. In my district, you are making a profit on the $500,000 loans, and that higher conforming loan limit is helpful.

I yield back.

Mrs. MCCARTHY OF NEW YORK. [presiding] Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you. Mr. Secretary and Commissioner, thank you for being here.

I want to go back to—and I am sorry I had to step out, but I want to go back to the risk-based pricing for just a minute because I think I have some disagreement here. But the current minimum downpayment is 3½ percent. Is that correct?

Secretary DONOVAN. That is correct.

Mr. NEUGEBAUER. And so the pricing on that is—if I go to counseling, I get a little better deal, and let's just say I didn't go to counseling. So if I have a 3½ percent downpayment, no-counseling loan, you are going to charge me 3 points up-front for insurance coverage. Is that correct?

Secretary DONOVAN. Actually, that is the statutory cap. But the current level is 1.75 percent up-front, plus .55 over time. That is for most of the loans. There is some variation in that.

Mr. NEUGEBAUER. So you are charging 1.75 percent right now, plus the 55 basis points. Now, if I make a 20 percent downpayment, what is the charge for that?

Secretary DONOVAN. The pricing is the same.

Mr. NEUGEBAUER. Yes. And is the risk the same?

Secretary DONOVAN. Depending on other variables, the risk may or may not be the same.

Mr. NEUGEBAUER. Now, you are saying—I want to be sure, Mr. Secretary. You are on the record telling me that you think a loan that has a 3½ percent downpayment is on parity with the same risk as someone who puts 20 percent down?

Secretary DONOVAN. I did not say that. What I said is you can't just look at the downpayment in order to be able to understand the riskiness of that loan. Let me just provide some details here.

For a 97 percent or 96½ percent loan-to-value with a high FICO score, we have very, very low default rates; whereas, on the other hand, you could have a high downpayment, a significantly higher downpayment with a lower FICO score, and in fact the performance is significantly worse. So I—

Mr. NEUGEBAUER. I understand that part. But I—

Secretary DONOVAN. I will agree—let me just agree with you that there is no question that the higher the downpayment, the less risk there is. But my only point I wanted to make is that it is important to look at the range of factors, not just at that one factor.

Mr. NEUGEBAUER. And I understand that. I mean, one of the things that got us in this situation is we were, across the country, loaning money to people who couldn't pay it back, whether it was car loans, house loans, all kinds of—and so one of the things we don't want to do is perpetuate that.

Secretary DONOVAN. Absolutely.

Mr. NEUGEBAUER. And so I am sensitive to the fact that, you know, we want everybody who can afford to buy a house to have the capacity to do that. We don't want the taxpayers, though, actually to have to somehow maybe subsidize that at some point in time.

But I don't understand the resistance. And I think, Commissioner Stevens, you said when you testified to this committee that you did not intend to implement risk-based pricing. So I still don't get that, because as Chairman Frank said a little while ago, there may be that $50,000- or $60,000-a-year individual, that single mom raising a couple of kids, and she may have made a 5 or 10 percent downpayment. She may have a better FICO score than someone with higher income. And we are not rewarding that behavior. We keep rewarding bad behavior because we are treating everybody the same.

That is what got us into this mess that we are in today. And so I am disappointed. A lot of us worked very hard to make sure that this risk-based pricing was on the table so that we could reward good behavior, and those people who have lower FICO scores because they have not demonstrated good behavior with their credit, that we are allowing them to get a free ride on those people who are actually out—when they buy a car, they pay for their car. They go buy a hot tub, they pay for their hot tub, or whatever it is they are buying.

And so you are going to have to explain to me why that is good policy.

Secretary DONOVAN. First of all, let me agree with you very clearly that we do not want to reward bad behavior, quite the opposite. Let me just take that example of someone who may have a very high—or want a very high LTV loan, have a poor credit score, a poor borrowing history.

First of all, as I said earlier today, we are going to impose a higher FICO limit. We are going to take other steps to ensure that kind of bad behavior isn't rewarded. But I want submit that allowing that person to get a loan and simply charging them more isn't necessarily going to lead to a better outcome. It might actually put them at greater risk of default than it would otherwise.

And I would submit that there are other ways to approach that same problem. For example, we might say that we would raise the minimum downpayment for low FICO score borrowers so that they couldn't get that high downpayment loan—that high LTV loan to begin with.

And so I think there are other ways of approaching risk and risk-based underwriting that aren't necessarily risk-based pricing. It is not to say risk-based pricing isn't an appropriate tool. I think the question is, is it the right tool for an organization like FHA to use relative to a private market player?

And again, I will reiterate, I do have some concerns that by raising pricing for certain borrowers and lowering it for others, we may actually be getting into a territory of competing against private capital coming back. And what I don't want to do is impede in any way the private sector returning as quickly as possible.

I think private sector risk-based pricing makes sense in a lot of cases. But I think we have to look at it somewhat differently for FHA, but to get to the same result that you are trying to get to, which is not to reward risky or bad behavior, but to reward good behavior.

Mr. NEUGEBAUER. Yes. And I agree that it has to be all of the above. I just hate to see you take risk-based pricing—what I hear you saying, I agree with the higher downpayment requirements for lower FICO scores, all of those things, looking at the total. But I hate to see you taking the risk-based pricing off because, you know, your fund isn't going in the right direction right now.

Mrs. MCCARTHY OF NEW YORK. Gentlemen, the time has expired.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Madam Chairwoman.

Welcome, Mr. Secretary. Frankly, much of what I heard in your testimony I agree with. And frankly, I rarely say those words to a member of the Administration.

Having said that, I am far more impressed by actions than words. But I am hopeful that what I heard in your testimony, see in your testimony, that there will certainly be follow-through. I have a great concern about the actuarial soundness of the MMIF.

The first question I have, I guess, is maybe help me with a little bit of historical context. I wasn't able to complete the study on my own. But just how often in the history of the fund have the FHA's secondary reserves been at this level? We know they are below the 2 percent statutory level. But how often has the reserve fund dipped to, I believe it is 0.53 percent?

Secretary DONOVAN. Well, the 2 percent requirement was actually created in the wake of the mid-1980's—

Mr. HENSARLING. Right. I understand that.

Secretary DONOVAN. —collapse that we had. And at that point when it was created, in fact, the reserve level was far below the 2 percent minimum. It took a number of years of growing the capital after it was established to get it above 2 percent. So it has been below the 2 percent.

This is the first time that it has dropped below the 2 percent since it went above that first time. But it has been below the 2 percent—

Mr. HENSARLING. I am sorry. Since the 1980's? After it—

Secretary DONOVAN. I don't have the exact date in front of me. I don't remember whether—I believe it was the early 1990's where it actually went above.

Mr. HENSARLING. Okay. Regardless, when one looks at the entire history of the fund—

Secretary DONOVAN. I am sorry.

Mr. HENSARLING. Yes?

Secretary DONOVAN. It was 1995 where the 2 percent was achieved. Between 1990 and 1995, it was below the 2 percent.

Mr. HENSARLING. In your testimony, Mr. Secretary, you say that, "As such, the actuary concluded that the FHA's reserves will remain positive under all but highly severe economic scenarios." I know you believe that. I hope that to be true.

You may have had come to your attention an editorial in the Wall Street Journal yesterday where now-OMB Director Dr. Peter Orszag back in 2002 wrote a paper, and I quote from it, "On the basis of historical experience, the risk to the government from a potential default on GSE debt is effectively zero." In that same paper, now-OMB Director Orszag—apparently they tested Fannie and Freddie "against the financial and economic conditions of the Great Depression."

I just say that, Mr. Secretary, again, some of us are skeptical, particularly when we look at what has happened to the unfunded liabilities of Social Security that weren't supposed to need taxpayer infusions; the Pension Benefit Guarantee Corporation; the National Flood Insurance Program; and now we know what the status of the FDIC fund is. It could be a matter of time before Chairman Bair is knocking on the Treasury's door for a line of credit there.

So I am concerned ultimately, notwithstanding your fairly sanguine posture, that we still have the fund in harm's way. And that concerns me greatly on a number of different fronts.

Number one, I believe everything that we do ought to be viewed through the prism of, what does it do for jobs? And I think the number one job of this Congress ought to be jobs. And unfortunately, since this Administration has come into power, we have had an additional 3½ million of our fellow countrymen lose their jobs.

The only thing I see that the stimulus has brought us is the highest deficit in the Nation's history, the first trillion dollar deficit, and rising unemployment.

I believe, frankly, that a lot of that is tied to the debt overhang, and the actuarial soundness of the MMIF, frankly, could be one more shoe to drop. And I don't know—at least when I talk to people in the 5th Congressional District of Texas, when they are looking at the possible monetizing of the debt, if they are looking at huge tax increases, when they are looking at further bailouts by this Administration, nobody wants to hire anybody. Nobody wants to launch a new enterprise.

And so I am just hopeful, and I see my time is running out, that what you said in your testimony you will do to ensure that the insurance fund does not need a taxpayer bailout, I hope you follow through. And particularly, I hope that you pay very careful attention to the legislation by the gentleman who is sitting to the left of me, the gentleman from New Jersey, who has legislation to increase the required downpayment for these FHA loans.

And in the conversation you were having with the other gentleman from Texas, certainly statistically and anecdotally the correlation between, as you put it in your own testimony, skin in the game—and default rates cannot be denied, and I hope that you will pay very serious attention to the gentleman's legislation—I see I am out of time.

Mrs. MCCARTHY OF NEW YORK. The gentleman's time has expired.

Secretary DONOVAN. If I could just—one comment. I do think if we look at the broader economic picture, first of all, the actions that we—I have talked about in my testimony, the actions that we have already taken are very much focused on exactly what you said, Congressman, which is ensuring the health of the fund. We are very, very focused on that, and it is a critical piece of our commitment to the taxpayer that FHA should be self-sustaining.

I would also add, though, that housing, as you know, is a critical part of economic recovery, and that without the important role that FHA is playing today in that economic recovery, I would submit that we would have lost many more jobs, and in fact, that the early signs of recovery that we have seen have begun to contribute to broader recovery in the economy overall.

So we shouldn't lose sight of the important job-generating role that FHA can play in supporting the broader housing market.

Mrs. MCCARTHY OF NEW YORK. Mr. Garrett?

Mr. GARRETT. Thank you. And I thank you, Mr. Secretary.

I think members on both sides of the aisle will agree with your last point, that we all want to make sure that the economy starts actually growing again. And to your point that housing can and will and should play a significant part of trying to get back on track, and we would like to see the housing market get back on track.

A caveat to that is, or the other element of that is, if FHA's situation continues to decline, if we get a worst-case or a bad scenario, and it deteriorates and we need to get to that bailout situation, that would be a horrendous situation for us to be in. And that would—I question whether we would be able to do that bailout again, in the light of the political realities.

And obviously, the situation then on the overall economy, if we get to the situation that FHA can't be there as it has been in the past to be the backstop, would be something that none of us would want to get to.

So how do we avoid that? And I think that is what we are talking about doing. You raised the point, and we have a chart over here and I think you will agree with what the point of this chart is, is that is the point of the correlation of default rate to the risk that is there.

And what we are looking at—and this is why I dropped in my legislation, because I have been concerned with this for several months; and this comes out of not just my thinking on it, it is also your own actuarial reports that says, "Based on previous economic studies and mortgage behavior, a borrower's equity position in a mortgaged house is one of the most important drivers of default behavior"—and I emphasize that point—"and the larger the equity position a borrower has, the greater the incentive to avoid default on the loan."

That is from your own reports, and I think you would agree with that as well because I know you said during your testimony that there is no single characteristic that is a driver. But your report states that this is probably the most important driver that is out there.

And as you see—and let me just give you a little information on the numbers that are here—this is like plain—these are plain vanilla numbers here, basically, purchase price; primary house; single family; very high, good FICO score over 700; full documentation; full amortization; and as we said in the bottom, enclose the volume or the sales from the sand States, or the States where you are having problems.

So this is the good stuff. And these show that those borrowers who put zero down are more than twice as likely to default as opposed to who put a downpayment of 5 percent. Twice as much. I mean, that is—I think that is significant.

And to take a page out of Mr. Hensarling's comment, we were here also when the GSE discussions were made several years ago, and some of us were arguing that it could be a systemic risk. And we were told not to worry about it, for the quotes that Mr. Hensarling made, and also from the chairman as well.

But now we are down $120 billion out of taxpayers' money. So some of us are, arguably or realistically, a little skeptical when we hear, "don't worry." And that is why I put in the legislation.

So let me just throw the question to you: What do you think of the legislation to simply say that we should have skin in the game; we are at 3½ percent right now, to go up to 5 percent; balancing everything out, trying to get the housing market to go again, would actually be beneficial to going forward?

Secretary DONOVAN. Well, first of all, Congressman, I would just like to clarify. I don't think anybody here today has said, "don't worry."

Mr. GARRETT. Okay.

Secretary DONOVAN. I don't think we have said we shouldn't take action. In fact, we have detailed actions today, and also talked about further actions that we will take. And on one of those, I think we agree: Increasing skin in the game for borrowers, as I said, is an important step.

What I want to make sure that we do is to do it in the right way based on the facts, and not to exclude borrowers who can be successful homeowners at very high rates, but to make sure that we target our actions on those who are most likely to default.

So what I would suggest, I would love to be able to come and sit down with you to go through detailed performance data as we are finalizing these changes, and to be able to give you a sense of our thinking on that, and get some feedback from you about the best way to implement this. I think all we are saying today is without the full facts on what those criteria should be, it isn't enough just to look at downpayment as the single factor, or even the single most important factor.

Mr. GARRETT. Well, reclaiming my time—I see we are coming to the end here—I think these facts are pretty substantial, when you see the default rate twice as much for just simply between 5 percent and zero percent. So really, even with all the other factors in consideration, I find that hard to argue. But I will be glad to sit down with you.

Secretary DONOVAN. I think it is—just one point I would make is the difference in performance between 97 percent and 100 percent is dramatic. And you don't have the 97 percent. I think what you are reflecting there is the performance of the downpayment assistance loans, which we no longer make.

Mr. GARRETT. Right.

Secretary DONOVAN. And so, again, I think it is important to get to the details of this so that we can show exactly what that performance looks like.

Mr. GARRETT. Right. And may I enter into the record, since the time has expired, two documents. One is from the Wall Street Journal, an article by Robert Pozen—which goes to the point Ms. Capito raised and I would have liked to have gone into—entitled, "The Homebuyer Tax Credits Threaten the FHA;" and another report by Amherst Securities Group, dated November 23rd, "Negative Equity Trumps Unemployment in Predicting Defaults," which basically goes to the point of the importance of having skin in the game as far as unemployment and other factors. So if I may enter those in the record as well.

Mrs. MCCARTHY OF NEW YORK. Certainly. I guess the question would be also—

Mr. GARRETT. If unanimous consent?

Mrs. MCCARTHY OF NEW YORK. Unanimous consent to put those into the record.

Mr. GARRETT. Thank you.

Mrs. MCCARTHY OF NEW YORK. I guess the question would be, and it would be interesting, how many of those that had the "zero-down" downpayments on some of their second homes because they had excellent scores at that particular time. That is something maybe we could look into for the future.

Mr. Green?

Mr. GREEN. Thank you, Madam Chairwoman, and thank you, Mr. Secretary and Mr. Commissioner.

Mr. Secretary, I heard some of your comments just a moment ago, and perhaps they were addressing a concern that you and I have been talking about with reference to downpayment assistance, seller-assisted. My thinking is you indicated that there are details that we need to take a closer look at as we explore the possibility of working with such programs, as I came in, as you were speaking. I am not sure what the entirety of your comments were, so I would like for you, if you would, to simply reiterate. I heard the comment about "skin-in-the-game," but reiterate if you would some of what you said about the downpayment assistance so that I might get some clarity. And I apologize to you for my late arrival. I have truly been engaged in some housing business in another sense. But thank you so much, and if you would?

Secretary DONOVAN. I think you probably heard the entirety of them. I was simply focusing on the details of the performance that was there and pointing out that the 100 percent loan to value performance there would have included the downpayment assistance loans, which no longer are an option within the FHA portfolio. So that was—I am guessing that you heard the entirety of my comments.

Mr. GREEN. Well, in that case, let us just for a moment talk about the seller-assisted program that we have been dialoguing on. Having looked at some of the statistical information, I understand why there can be a great deal of consternation. My hope is that the program, while it has had some concerns that have to be addressed, there may be a means by which we can continue to work to see if there is a way to have some program, not the program that we had before, but start anew and let us develop a program that can be successful for persons who can pay for a home but who are without the necessary downpayment.

Secretary DONOVAN. Congressman Miller, who was here earlier, talked a little bit about this. As I said at that point, I think the biggest concern and issue is about having an interested party in the transaction providing a downpayment. Certainly under our rules, we allow a family member to provide it. There are certain State housing agencies or others that can provide it effectively. I have seen that in my own experience. But the most significant issue has been that you have an interested party, the seller, providing that downpayment, and that has been I think what has led to the incentives that drove the program in the wrong direction.

Mr. GREEN. I understand, and there are ways to deal with the interests that you have called to our attention. We have talked about the blind pool appraisal process. There are other ways that it can be dealt with. So my concern is that we continue to look at means by which we can accomplish this so that we do not find ourselves with persons who truly cannot afford to pay for homes and just lock them out because they do not have that downpayment assistance. And I greatly appreciate family-supported downpayments, and there are municipalities that are into this, as I understand it, and other agencies as well. But there are some people who but for that downpayment could afford to make a mortgage payment. In fact, I am sure you can cite examples, as can I, of persons who are paying more in rent than they would pay for a mortgage if given the opportunity to have one. That is where we are.

And I do not think that we are that far apart. I think that we just need to continue the dialogue. I appreciate the way you have embraced this in terms of working with us to help us move forward and hopefully come up with something that will assure us that we will not have a flawed program but rather a program that benefits the intended parties in such a way as not to allow some of the things that occurred prior to this moment to occur again.

With that, Madam Chairwoman, I will yield back.

Mrs. MCCARTHY OF NEW YORK. Thank you. Mr. Posey?

Mr. POSEY. Thank you, Madam Chairwoman. Mr. Secretary, I wonder if you could take just about 30 seconds and summarize with me your focus on manufactured housing?

Secretary DONOVAN. Is there any particular aspect of it that you are—

Mr. POSEY. No, just what your focus is on it right now?

Secretary DONOVAN. I would turn to Commissioner Stevens for further details on it. I think there are effectively two major areas that we are focused on. One is the implementation of our regulatory oversight responsibilities around it. And the second is obviously the significant lack of financing in the market that exists today and whether there are ways that we can effectively ensure better financing options for manufactured housing.

So those are I think the two most significant areas of regulatory responsibility and other responsibility that we have to sort of guide our involvement, if you will.

Mr. POSEY. Do you consider it a priority?

Secretary DONOVAN. I do consider it a priority. I would say that given the nature of the foreclosure crisis and the current condition of the fund, I think our primary focus has been, as we have talked about today, stepping up the quality of the lending that we are making as well as the important return of the capital fund above 2 percent. So I would say that that has been my primary focus within FHA.

Mr. POSEY. As you are aware, the position of the appointed noncareer administrator for the HUD manufactured housing program as authorized by Congress in the Manufactured Housing Improvement Act of 2000 still remains vacant to this day, I understand. And obviously, this affects everything relating to federally-regulated manufactured housing, including financing. And I just wonder if you ever plan to appoint anybody?

Mr. STEVENS. First of all, I appreciate the question, and the manufactured housing issue is an area that we have spent a great deal amount of time talking about. I have met with Mr. Ghorbani several times. It is a difficult subject in terms of the Schedule C request that Mr. Ghorbani is asking for as it relates specifically to the manufactured housing piece.

Mr. POSEY. Who is asking for it?

Mr. STEVENS. The representative of the manufactured housing trade organization.

Mr. POSEY. I have never talked to them.

Mr. STEVENS. Okay. But just to put it in perspective, of the roughly 2 million transactions done in the single-family business in

Fiscal Year 2009, 46,000 of those were manufactured housing transactions. Our regulatory group, we have a regulatory team that focuses in a significant way on the manufactured housing issues from inspectors to requirements, both from the manufacturers and the property owners who lease out land for manufactured housing properties to reside on. So we do focus on the issue quite a bit. The question is whether a specific political appointee is needed to run that organization, which is the one issue that we have been discussing with the industry, and that is the area that we are continuing to discuss with them.

Mr. POSEY. Well, it was authorized by Congress in 2000. You have studies for 8 years. Do you have an opinion yet?

Mr. STEVENS. Quite frankly, I would say that I am not confident that having a political appointee, Schedule C, given the limited number of those positions that are allocated to the Department is warranted by the manufactured housing industry.

Mr. POSEY. Okay.

Mr. STEVENS. But I will tell you this, I am agnostic, I am very open, and I continue to listen to it. I have spoken about it briefly with the Secretary. We continue to look at the issue. The question is, would creating a Schedule C position have a measurable impact that would improve the outcome for the manufactured housing considering the vast number of resources and time that we all spend focused on this?

Mr. POSEY. So you think Congress is wrong in authorizing the position then; you think it was stupid of Congress to do that?

Mr. STEVENS. No, I think it was—I greatly appreciate the opportunity which says we may appoint, the Secretary may appoint, and we clearly would absolutely take advantage of that if the need was prevalent. And based on when the legislation was passed versus the state of the manufactured housing industry today and the vast number of resources we have working on the subject, from the General Counsel—in fact, the General Counsel and I have had discussions on this particular issue as recently as this morning. It is a question of whether that is warranted given the limited number of Schedule C's allocated for the Department.

Mr. POSEY. Four to 6,000 is not a small number.

Mrs. MCCARTHY OF NEW YORK. The gentleman's time has expired.

Mr. POSEY. To most people really.

Secretary DONOVAN. If I could just add one other thing. First of all, to be fair to Commissioner Stevens, he has been on the job just a few months, so this is not something that he had a significant amount of time to consider. But also I would say one of our primary focuses has been that we were given new authority under HERA to be able to make a substantial number of improvements in our approach to manufactured housing, which we have gone ahead and implemented. And I think have made a real difference. So that has been the primary focus of the work that we have done on manufactured housing this year, and I do think we were able to accelerate substantially the implementation of those provisions compared to what the prior Administration had been doing. So, thank you.

Mrs. MCCARTHY OF NEW YORK. Ms. Waters?

Ms. WATERS. Thank you very much, Madam Chairwoman. I would like to thank Secretary Donovan and Commissioner Stevens for being here today. It is so busy. People are running all over the place, and we are committed to several committees at a time. But, as you know, I am extremely supportive of FHA. And I am concerned.

And I think, Commissioner, when you testified before, we did know that FHA's capital ratio was going to be what it is. We thought it was going to be a little bit stronger than that, and so we really do have to take whatever steps are necessary in order to make sure that we have the capital ratios that we should have. But let me ask you this: I understand that you have the authority and the ability to determine the credit scores that would be eligible for FHA financing, is that correct?

I suppose that as you consider what restructuring you are going to do or what changes you are going to do, you will take that into consideration. But given all of this, I would like to just share with you a part of the testimony that I had prepared, which says, "Given FHA's historical success at bringing homeownership to millions of households, I do not believe that strong oversight should be confused with the need to curtail the role of FHA to the point where a housing recovery becomes impossible and only the most affluent households have access to homeownership. We need to be careful that any changes we propose would actually improve FHA's solvency rather than simply drive away qualified borrowers."

I read you this part of my statement because in essence, that sums it up. And we think that in this economic crisis that we are in, where we have an unprecedented number of people whose jobs are being downsized or are losing jobs, we could easily get confused and think, oh, we cannot do anything much anymore. But I think that FHA's history is much stronger than that, and we should use every opportunity to figure out how to keep FHA going and going strong and making it available to all of these people who deserve it at the same time managing in ways that will not drive us deeper into capital ratio problems, okay.

Thank you very much. I yield back.

Secretary DONOVAN. Madam Chairwoman, it is great to see you, and thank you for being here. If I could make just two brief comments on that?

Ms. WATERS. Yes.

Secretary DONOVAN. First of all, I think you highlight the very, very important point that homeownership should be available to responsible buyers who can be successful at doing it, and that we have to, as I said in my testimony, keep an eye on FHA's historic role in doing that.

One of the reasons why we have focused so heavily on enforcement is that what it allows us to do is to very clearly target those loans that will be most likely to cause problems for the strength of the FHA fund without disqualifying any deserving borrowers. So that is a first important step.

Second of all, as you may not have heard in some of my earlier discussion, we have to be very careful about using just a blunt instrument in terms of the way that we set our policies. We have to look at the combination of factors that lead to high risk and not just whether it be on loan to value or on some single characteristic, like a FICO score, that is the only criteria that we are taking into account. And so that is why we are looking very carefully at the combination of factors. I think it would be important that we come and sit down with you and talk in more detail about our thinking on that so that you can get a clear picture of our thinking, and we can get your input on that as we go forward on these changes.

Ms. WATERS. Thank you very much.

Mrs. MCCARTHY OF NEW YORK. Thank you. I want to thank Secretary Donovan and Commissioner Stevens for your testimony today. I happen to agree with you, Secretary Donovan, that there are a lot of people out there who could actually buy a house who probably have not gone forward because they are afraid they cannot buy a house. I have to remember when I first bought my first home, it was my parent's home, and I think the price of it when they bought it was $12,000. When I bought it, I think it was $85,000. Right now, so they tell me, it is worth about $525,000. I am sure that has gone down. Unfortunately, my taxes have not gone down on that.

But I think when you look at people who actually work hard, their dream is to have a home. Those who have been living in apartments, paying their bills, utilities and everything else that goes with it, actually usually end up being good customers even when they are buying a house. These are unusual times. People are losing their jobs. And for the first time, they are finding themselves in financial problems, so hopefully we can work that out and get this economy going. Get the jobs back. And I think then we will see the housing turn around.

Thank you for your testimony. We appreciate it.

If the second panel would come forward. The Chair notes that some members may have additional questions for this panel which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

I want to thank the second panel for your patience. I know Ms. Waters touched upon it. There are many, many hearings going on throughout the House. There is also a caucus meeting going on where a lot of members are. So I thank you for your patience as we go through that.

I would first like to introduce Ms. Ann B. Schnare. Am I pronouncing that correctly, "Schnare?" Ms. Janis Bowdler, Ms. Vicki Golder, and Mr. Robert Story. You will see members coming in and out, as you probably have noticed, as they get free time.

With that, if you would start, Ms. Schnare?

STATEMENT OF ANN B. SCHNARE, PARTNER, EMPIRIS LLC

Ms. SCHNARE. Thank you, and good afternoon. I would like to thank the chairman and the ranking member for inviting me here today. My name is Ann Schnare. I am a Ph.D. economist who specializes in housing and mortgage finance.

Last year, I co-authored a study that predicted that FHA would fall below its 2 percent capital requirement by the end of Fiscal Year 2009.

Let me begin by emphasizing the critical role that FHA is playing today. I fully agree with what the Secretary said about FHA's continued presence in the market and how it is essential to housing recovery. At the same time, there are clear indications that FHA is under stress. Delinquencies continue to rise, the share of loans in troubled housing markets continues to grow, and many FHA mortgages continue to be originated at loan-to-value ratios that are close to 100 percent. While credit scores are rising, this may not be enough to protect the fund.

The recently released audit found that the fund has basically run through most of its capital reserves and no longer meets its mandatory 2 percent threshold. Under the base case scenario, the capital ratio is about 0.53 percent, which from a statistical point of view, is not much different than zero. Although I have not attempted to replicate this year's audit, I believe that the base case projections are probably optimistic and that the fund is most likely facing a significant capital shortfall.

One of the major shortcomings of the audit is that it did not consider the current delinquency status of FHA loans. The audit projects that roughly 116,000 loans will default in Fiscal Year 2010. Yet, 108,000 loans are already in the foreclosure process and new foreclosure starts have been averaging about 11,000 loans per month. Unless one assumes that a higher percentage of these loans will cure, which seems highly unlikely, the claim rates projected in the baseline projections appear to be too low.

In addition, the audit projects future house price trends at the national level, not the regional level, and as a result, might not be capturing the impact of the changing geographic distribution of funds. In the audit that we did last year, we found that further increased the projected losses of the fund.

And last but not least, the economic assumptions that underpin the audit may prove to be optimistic, particularly as they relate to house price trends in 2011 and beyond. For all of these factors, I think that FHA is at best running on empty and probably is facing a negative capital situation.

I applaud the Secretary for his announcements that he made today, and I believe that HUD is moving in the right direction.

I would like to use my remaining time to reiterate some of the recommendations that are presented in my written report. The first is to make FHA's financial condition more transparent. Waiting another year for the next financial audit is unacceptable in the current environment. FHA also needs to provide more meaningful reports on its risk exposure on the ongoing performance of its loans. This should become a priority at HUD and it should be disclosed to the public.

Second, FHA should increase its downpayment requirements. While FHA borrowers are required to put 3.5 percent down today, they are allowed to finance the up-front premium and a portion of their closing cost. As a result, many FHA borrowers go into their homes with little, if any, equity. HUD's announcement that it will begin to require more skin-in-game will be good for borrowers and neighborhoods alike.

Third, FHA should begin to recapitalize the fund by enacting a modest increase in its insurance premium. In my view, increasing the annual premium is the way to go. When we looked at this issue last year, we estimated that a roughly 20 to 25 basis point increase would have enabled the fund to remain in compliance with this capital requirement. Something along these lines would probably be appropriate today.

Fourth, FHA needs to audit every loan that defaults within its first 12 months. Early payment defaults typically stem from shoddy underwriting practices or outright fraud. Rather than routinely paying claims, FHA should take steps to ensure that applicable guidelines have been met and crack down on offending lenders. The provisions contained in H.R. 3146 are an important step as are the announcements that the Secretary made today.

Finally, the role and structure of FHA needs to be reconsidered. FHA has long been plagued by resource constraints, an inability to attract and maintain qualified staff, and a lack of autonomy. Going forward, it is critical to give FHA the resources, flexibility, and oversight it needs to serve its public purposes and maintain the integrity of the fund.

When I prepared my comments for this hearing, HUD had already taken important steps to improve its risk management controls and return to quality underwriting. The announcements made today provide further support for these basic objectives.

In closing, I would like to thank you again for giving me the opportunity to express my views. I am a long-time supporter of both FHA and affordable lending. I hope my comments can make a contribution.

[The prepared statement of Ms. Schnare can be found on page 76 of the appendix.]

Mrs. MCCARTHY OF NEW YORK. Thank you very much.

Ms. Bowdler?

STATEMENT OF JANIS BOWDLER, DEPUTY DIRECTOR, WEALTH-BUILDING POLICY PROJECT, NATIONAL COUNCIL OF LA RAZA (NCLR)

Ms. BOWDLER. Good afternoon. My name is Janis Bowdler. I am the deputy director of the Wealth-Building Policy Project at the National Council of La Raza.

NCLR is committed to strengthening America by promoting the advancement of Latino families. I would like to thank the chairman and ranking member for inviting me here today.

FHA has a critical role to play in helping our Nation's economy recover, which has been discussed at length today. We have done a lot for the lending industry, but unfortunately, we really have not done enough to help average everyday Americans get back on their feet. We are seriously concerned about the lack of progress in stabilizing Latino communities. Our families continue to be hit hard by foreclosures and unemployment.

We know that middle- and working-class families will not recover until jobs return to their neighborhoods and the housing market is stable. On this last point, there is much that FHA can do.

In my testimony today, I will discuss the role of FHA in improving housing conditions for all families. And I will close with recommendations on how we can strengthen the program.

FHA is a critical government tool that is mission-driven to open homeownership opportunities and protect families from foreclosure. The program has seen its share of challenges over the course of its history. Still, FHA has been a standard bearer for affordable lending to low-income families. By providing mortgage insurance, it has reduced downpayments and standardized the 30-year fixed-rate mortgage. Perhaps its greatest success is teaching the private market how to lend sustainability to those of modest means.

During the subprime boom, FHA's share of the market dropped dramatically. While the reasons for this may up for debate, the impact is clear: Millions of families who could have qualified for an FHA loan ended up with a toxic mortgage. Arguably, many would not be facing foreclosure today had they been steered towards a FHA loan instead of a predatory one.

This year alone, 700,000 Latino and African-American households will lose their primary source of financial security, their home, to foreclosure. This is unacceptable. We need a robust FHA program that can offer a competitive alternative to predatory loans.

And, of course, the silver lining of the housing bubble is that many are finding homes in their price range for the first time. Unfortunately, at the same time, credit is drying up and many qualified families cannot get a loan.

I am sure you can imagine the frustration in our communities and working-class neighborhoods across the country who are facing high foreclosure rates, record job loss, and skyrocketing debt, and now families who are otherwise qualified cannot take advantage of the affordable market. Neighborhoods in this position are really looking at defeat. Distressed communities are seeing ownership opportunities slip away and investors and speculators are moving in to take advantage. This is where FHA can help.

NCLR is pleased with the progress they have made so far and with many of the recommendations that have been announced. They moved quickly to lend where the market would not and, as the Secretary mentioned, 45 percent of Latino borrowers used an FHA loan last year.

The importance of this cannot be understated. We understand concerns around the increased claims rates, but FHA cannot let tough economic times jeopardize its mission to serve first-time home buyers. This is not to say that there is not room for improvement. We are outlining three areas of the FHA program that can be strengthened to better serve borrowers and taxpayers. The first has been discussed at great lengths and that is looking at how we can crack down on fraud and predatory lenders that have moved out of the subprime market, which does not exist, and into the FHA system. Most of the claims are due to economic conditions and to some bad lender behavior, not necessarily the product itself. We should really focus on cleaning up the originator eligibility list.

Second, is the product design. FHA's success has largely been due to the product's flexibility. And the low downpayment requirements, for example, have made FHA accessible to millions of Latino and borrowers of all backgrounds. Such aspects of the program should be maintained. However, several years ago, FHA removed an important risk deterrent, the requirement for first-time home buyers to attend homeownership counseling. Buyers that attend counseling are far less likely to default. NCLR recommends creating incentive in the form of a premium discount for those who attend pre-purchase housing counseling with a HUD-approved agency.

And, finally, something that has not been talked a lot about is their loss mitigation strategy. FHA has some of the best tools to prevent foreclosures, but unfortunately, not all FHA borrowers are able to take advantage of them. While FHA servicers are required to make these available, there is little monitoring to make sure it happens and even less enforcement. NCLR recommends that servicers be required to prove to FHA that all foreclosure prevention options have been exhausted before they are able to file a claim.

Thank you, and I will be happy to answer any questions.

[The prepared statement of Ms. Bowdler can be found on page 45 of the appendix.]

Mrs. MCCARTHY OF NEW YORK. Thank you very much.

Ms. Golder?

STATEMENT OF VICKI COX GOLDER, PRESIDENT, NATIONAL ASSOCIATION OF REALTORS

Ms. GOLDER. Thank you, Madam Chairwoman, and members of the committee.

Mrs. MCCARTHY OF NEW YORK. Would you put the microphone on?

Ms. GOLDER. There we go, it is on. Thank you, Madam Chairwoman, and members of the committee. My name is Vicki Cox Golder, and I am the 2010 president of the National Association of Realtors. I own Vicki Cox and Associates in Tucson, Arizona, and I am here to testify on behalf of 1.2 million members of the National Association of Realtors regarding the audit that the Federal Housing Administration mortgage insurance program just had.

I am going to summarize three main points of my written testimony: One, FHA is a critical part of American housing markets; two, FHA is fiscally sound with responsible underwriting; and three, FHA needs enhancements, not radical reform.

With the collapse of the private mortgage market, the importance of FHA has never been more apparent. Thus far in 2009, nearly 80 percent of the FHA purchasers were first-time home buyers. In 2008, more than 60 percent of home purchase loans and almost 40 percent of refinanced loans were to African-American home buyers and were from either the FHA or the VA financing system. Nearly 50 percent of non-white, Hispanic borrowers used FHA or VA for home purchase loans and 21 percent used FHA or VA to finance a home loan.

If you take a closer look at the numbers, you will see that the FHA is doing exactly what they were designed to do, which is to serve the underserved. FHA is perfectly serving its role to fill the gap during this current crisis that we heard so much about by Mr. Donovan. And, of course, the mortgage insurance is so important and available to all qualified people and in all economic times, so it is important in good times and in bad.

In my home State of Arizona, you all know that we were hit very hard by the foreclosure crisis. FHA sales have grown more than

600 percent. If it were not for FHA, we probably would not have any market in Arizona right now. Without FHA mortgage insurance, we just would not be able to recover in our State.

Much has been made recently of the fact that the FHA's Capital Reserve Fund has fallen below the congressionally-mandated 2 percent ratio. While this is a sobering fact, it must be evaluated in its proper context. The decrease in reserves is not tied to excessive increases in defaults or unsound underwriting practices. Quite the opposite, FHA borrowers have higher FICO scores and lower loan-to-value ratios than ever. The overall decline in reserves is simply a reflection of the projected change in home price values. According to the audit, if FHA makes no changes to the way they do business today, the reserves will actually exceed 2 percent in the next several years. FHA has sufficient reserves. The cash reserves and capital reserves give the agency combined assets of $30.4 billion, enough to pay all claims over a 30 year period with excess above that. By comparison, the Financial Accounting Standards Board only requires financial institutions to hold reserves for losses over the next 12 months. In short, FHA has 30 times the level required by the FASB.

Realtors strongly believe that FHA is taking necessary steps to assure its financial solvency. Specifically, we applaud the hiring of an experienced chief risk officer to oversee FHA's efforts to mitigate risk. Realtors also support FHA's net benefit requirement to ensure consumers are refinancing without receiving any benefit. We also support FHA's aggressive stance against abusive lending.

We urge Congress and the Administration to tread lightly before making changes to a program that has such a profound impact on our economic recovery and serves such a critical role to our Nation's families. We strongly oppose H.R. 3706, the FHA Taxpayer Protection Act of 2009, which proposes increasing FHA's downpayment requirement. Such action would not add a penny to FHA's reserves, yet it would certainly put homeownership out of the reach of many creditworthy borrowers.

Realtors believe that the best way to ensure FHA's success is to strengthen it. A special thanks to Chairman Frank and other members of this committee for passing legislation to extend the loan limits through 2010. But, as the chairman understands, these need to be made permanent. Realtors strongly support legislation by committee members Sherman and Miller, H.R. 2483, which would do just that.

While some have argued that higher loan limits put the fund at further risk, in fact the opposite is true, and we heard that from Secretary Donovan today. FHA's audit demonstrated that higher balance loans perform better than lower balance loans. And despite long-held beliefs, higher loan limits are not just for California, New York, and a few other States. There are currently 246 counties in 28 States that have high cost limits. So this is truly a national issue. I know in my own State of Arizona, we have one county that would be considered a high-cost county.

In conclusion, I want to thank officials at HUD and FHA for the tremendous leadership and strength they have shown during the current housing crisis. I especially want to thank Congress for the recent law to extend and expand the home buyer tax credit. Without it, our housing recovery would have stalled, as all of you know.

Realtors know that they can trust FHA to help serve the needs of hard-working American families who wish to purchase a home. And I want to thank you all for allowing me this opportunity to testify. Thank you.

[The prepared statement of Ms. Golder can be found on page 64 of the appendix.]

Mrs. MCCARTHY OF NEW YORK. Thank you very much.

Mr. Story?

STATEMENT OF ROBERT E. STORY, JR., CMB, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION (MBA)

Mr. STORY. Thank you, Madam Chairwoman. My name is Robert Story. I am the chairman of the Mortgage Bankers Association and also the CEO and president of Seattle Financial Group.

Given the heightened role FHA is playing in our country's housing market, today's hearing is both timely and vitally important. Last month's report on FHA's financial situation was a wake-up call to all of us. It raised the urgency for strengthening the important agency so they can continue to serve borrowers and provide liquidity to our struggling economy.

At MBA, we have set forth a plan that we believe will help to strengthen and modernize FHA. And, today, I will provide some brief points on our proposal.

The report issued by FHA in November revealed that FHA's capital ratio has fallen well below the required 2 percent. But given the state of the economy, this should not surprise anyone. FHA is not immune from the problems that have hit the entire housing sector from small mortgage firms to giants like Fannie Mae and Freddie Mac.

Additionally, rising unemployment has led more FHA borrowers to fall behind on their mortgages. Falling home prices have resulted in more foreclosures and greater losses on each property. Add to that FHA's mission of helping underserved borrowers, and you can understand why the agency's reserves are being affected.

While an analysis of the report raises serious concerns with FHA, there are also reasons to be optimistic. FHA has taken a number of proactive steps to improve its risk management. And I want to commend Secretary Donovan and Commissioner Stevens for their aggressive approach. Improvements to FHA's appraisal procedures, the streamlined refinance program and lender approvals are all intended to put FHA on a sounder financial footing. We also look forward to reviewing the proposals Secretary Donovan laid out this afternoon.

I would also note that FHA no longer insures loans with seller-funded downpayment assistance. The report found these loans bear primary responsibility for FHA's decline in reserves. If we are to remove these loans entirely from the analysis, FHA's capital reserves would be above the required 2 percent.

Even with stronger underwriting and a ban on seller-funded downpayments, it is clear that more needs to be done. In recognition of this, MBA has put forward a proposal that will help bring

FHA into the 21st Century, and we are working on additional recommendations.

First, Congress needs to appropriate the funding it authorized under HERA for FHA staffing and technology needs. Also, allowing FHA to hire additional staff to keep up with is growing loan volume and good management. FHA makes money for the Federal Government. It should be allowed to use some of its money for its own staffing and technology needs. FHA should also be permitted to compensate its staff at the same pay scales used by other Federal financial regulators.

I want to commend this committee for supporting H.R. 3146, the 21st Century FHA Housing Act, which authorizes an additional $72 million annually for FHA. Now, we need to redouble our efforts to make certain this money is appropriated.

Second, we need to improve the quality of FHA originations. One way to protect the soundness of FHA is to ensure that FHA mortgage lenders and brokers are equipped to protect consumers and taxpayers from undue loss. At MBA, we strongly believe that rigorous licensing and registration requirements, as well as increased net worth and minimum bonding requirements, are essential components of any framework.

Madam Chairwoman, my company has been making FHA loans since the 1950's. In all of our experience, I cannot think of a more important time in FHA's history than now. MBA appreciates all that FHA is doing to provide stability, liquidity, and affordability during this difficult economic downturn. I would not want to envision a mortgage market without it. Were it not for FHA, many Americans would not have access to record low interest rates, tax credits, and other measures intended to preserve homeownership and jump-start lending.

I want to close by urging this committee to be proactive and to take the steps necessary to make sure FHA is there now and in the future serving potential homeowners and supporting our mortgage market.

Thank you.

[The prepared statement of Mr. Story can be found on page 82 of the appendix.]

Mrs. MCCARTHY OF NEW YORK. Thank you very much for your testimony. Thank you all for your testimony. It is interesting sitting here in this chair because you have to basically stay on your toes and listen to every word that is being said. But I think it is interesting—on a number of things that a lot of you said. When we look at the foreclosures that we have unfortunately seen in the last year or so, and we talk about the predatory lenders, Ms. Golder, you are representing the real estate people, Mr. Story, you are representing the mortgage bankers. And I guess the curious question that I have from listening to you, being that so many bad loans were made over these years, new products as they call them, I am wondering if being that a real estate person usually has to basically bring the buyer to the house, I would take it that a lot of your real estate people probably saw some of these people being led down the garden path on, yes, you can afford this house with this kind of a mortgage. Have you heard any stories where the real estate people really wanted to kind of warn the consumer at that particular point that there were better loans out there for them?

Ms. GOLDER. Quite frankly, I have not. I am mostly in the land business, but you have to realize that Realtors are basically successful based on our reputation. So the skin-in-the-game that we have is our reputation within the communities, our involvement within the communities. It is not our job also to recognize whether someone is qualified. We normally send them to a mortgage lender.

Mrs. MCCARTHY OF NEW YORK. Right.

Ms. GOLDER. And it is between them and the lender as far as what they are qualified for, and then they tell us what they are qualified for and what price to—what house that they want to see. And then it is up to once they go into escrow, all of that usually—in Arizona at least—is taken care of in an escrow account. I know in other States, it is between lawyers, that addresses it. But we do not see nor do we ask for that kind of information as far as wanting to—

Mrs. MCCARTHY OF NEW YORK. No, no.

Ms. GOLDER. And we also, as the National Association of Realtors, I want you to know we have produced predatory lending brochures. We did that clear back in 2005. So we try to educate our members as to exactly what predatory lending is.

Mrs. MCCARTHY OF NEW YORK. Well, that is basically—I am not putting any of this on your shoulders.

Ms. GOLDER. Yes.

Mrs. MCCARTHY OF NEW YORK. It is just that I know that I had heard from real estate people that they would basically look at some of what their consumers were buying, and they would say, how are they going to pay for this? I know it is not your—but I am just wondering in my own mind that it should not just be one person, whether it is the mortgage banker or whoever is looking at this, that maybe for the future we need more eyes.

Ms. Bowdler?

Ms. BOWDLER. NCLR is a large housing counseling intermediary funded by HUD.

Mrs. MCCARTHY OF NEW YORK. Could you bring your microphone a little bit closer?

Ms. BOWDLER. Sure. NCLR supports housing counseling agencies. We are a HUD housing counseling intermediary. Housing counseling agencies across the country really work primarily with the same demographic of FHA borrowers. And it was certainly the feeling of counselors that they were in the position of, if you could say it this way, making the borrower "eat their veggies," and say—you know, give them the hard news of here is what you are going to have to do in order to qualify for a loan. And there were certainly plenty of other good actors out there who were doing that. And the problem really was, I think what we saw in the market, is bad practices really drove out good. So for every housing counselor, real estate agent or lender out there who said, this is a bad idea, you had five more brokers who said, "Why wait? I can get you into a house today." And there were no protections in place to prevent that.

And a lot of times the consumers, it came down to a battle of experts. You have an expert across the table saying, "Yes, you can do this. I can help you do this." They took advice from the wrong people. But there were certainly those out there who were giving advice to the contrary, counselors, Realtors, brokers, but we could not be heard above the roar of the predatory folks.

Mrs. MCCARTHY OF NEW YORK. And part of the legislation that hopefully we will see on the Floor in the next couple of weeks, there is going to be a very large part on consumer educational programs, financial literacy. I am a great believer in being educated because a lot of us, when we bought our first home, did it the old-fashioned way. You had to show you could afford the taxes, you could pay your insurance, and all the other issues that it takes to basically run a house. It is not just paying the mortgage. There is a lot more responsibility, so I certainly support that.

Mr. Story, this committee has just approved a systemic risk bill that would require lenders and securitizers to retain 5 percent of the credit risk of any mortgage they sell. Given the importance of FHA to the housing market, should we consider exempting certain qualified mortgages, like FHA loans, from risk retention?

Mr. STORY. Yes, I think that should be a consideration for a number of factors. One is that we heard earlier today that the FHA is going to do a more stringent underwriting process as well as they are going to spend more time evaluating lenders who sell them loans and have a list of lenders and their percentage of success I would suggest. The outcome of getting a loan put back to the lender is certainly skin-in-the-game if they are asked to repurchase a loan in a timely manner. So I think that is sufficient.

Mrs. MCCARTHY OF NEW YORK. My time is up. Thank you. Mrs. Capito?

Mrs. CAPITO. Yes, thank you. Ms. Schnare, thank you for the suggestion, it was your suggestion to have rather than just an annual audit, to have something—and you heard the Secretary's response. Are you satisfied that—I mean he said they were looking at this daily. I asked for maybe a twice-a-year kind of assessment. You are in this business. Do you think that is not just a step in the right direction but is sufficient to be able to detect what direction we are going and if improvements are being made?

Ms. SCHNARE. There are a number of things that should be done, which I heard them saying they intended to do. And one is more regular updates of the audit. That is a fairly formal process. But there are other things that do not now exist at HUD that I understand they are in the process of developing, which are targeted risk management reports to give key indicators. Looking at how loans are performing by the age of the loans, which I could not get the data on. Looking at mark-to-market LTV distributions. I think given their backgrounds and experience in the industry, they are going to produce monthly reports, weekly reports that give a lot more information than they give today, and I think they really are—if they do what they said they would, there is going to be a huge difference because those kind of reports have not existed at HUD.

Mrs. CAPITO. Well, I will say that the fact that I think they said that 70 percent of the non-performing loans now are the older loans or that are already on the books or 70 percent of the ones that are predicted to default are already there. So I think they are maybe looking at certain factors and indicators there.

The question that I am concerned about, and anybody can answer this, although I think Ms. Golder probably might have the better handle on it, is the term of the still-falling real estate prices. So if HUD is out there making a $250,000 guarantee—loan on a guarantee, and they are in a region of the country where the prices are still falling, that to me would further endanger the fund. So what kind of comment do you have in terms of how we are looking out for this still constantly falling value in our real estate market?

Ms. GOLDER. Probably the best answer would be to ask Lawrence Yun, who is our economist who would know whether or not they are falling. But, as we have said, in the last 7 months, we have seen prices stabilize and the market starting to improve. And I think we are seeing most markets across the country are stabilizing and rebounding, even California where they usually take the dive first. The East Coast, where you are familiar, Long Beach and up in the Connecticut area, prices have stabilized. So I do not believe you have to worry about prices dropping much more. They do appear to be stabilizing clear across the country.

Mrs. CAPITO. Does anybody else have a comment on that?

Ms. SCHNARE. I think it varies by market. And one of my concerns is whether or not FHA is increasing its share in markets that continue to decline, and I think that is the concern about very high LTV loans. If you basically have no money down and the market declines, and you lose your job, the only choice you have is really to default.

Mrs. CAPITO. Right.

Mr. STORY. Yes, I would just say that as an economic consideration it is probably more of a concern given the fact that interest rates are at historic lows and most people are being underwritten very stringently and going with 30-year fixed-rate mortgages, which given the stringent underwriting standards, as long as they stay employed they should be able to continue to make their payments.

Mrs. CAPITO. Could I ask you a question, Mr. Story, then on the loans that you have closed over the last, let's go back to 2005, of 100 loans, how many of those would have been FHA? And then if you look at the end of 2009, where we are now, what percentage of that?

Mr. STORY. For my company? Or in the industry?

Mrs. CAPITO. Your company, yes.

Mr. STORY. I think FHA was 2 to 5 percent in 2005, and it is anywhere now between 30 and 45 percent.

Mrs. CAPITO. And what do you attribute that mostly to?

Mr. STORY. I think a lot of the purchases now are first-time home buyers and they are new construction, and those are typically for that type of borrower goes into a FHA loan. There are not a lot of— terrible amount of products like there once was. There is a limited amount of types of loans you can get. And the people who are professionals in our business, a lot of them have been in the business for a number of years, do know how to do FHA financing and it has become a better option for some people.

Mrs. CAPITO. I think my time is up. Thank you.

Mrs. MCCARTHY OF NEW YORK. I am just curious, Mr. Story. When you say that you do an awful lot of the FHA loans, we also see an awful lot of the banks that are not making any loans. We see more certainly, and probably, Ms. Golder, you probably want to jump into this too, I know a lot of the community bankers, which usually work in the community, the smaller bankers, and they usually know their customers a little bit better, so between the two or any of you who are seeing this, are you seeing where it is easier for the average person who wants to get into buying a home because the prices have dropped, which is probably evening the market a little bit. I look at my house in Mineola. I could not believe that somebody would want to pay $525,000 for it. It is a tiny little home. It was my parents'. It was built in 1948. But yet, they were telling me at one point, it was worth $575,000. Now, certainly I would love to take that, but I do not think that is going to happen. Are you seeing with local community bankers are opening up for loans or are they still holding back?

Mr. STORY. Well, my company also has a small community bank. Those that are in lending for purchases of homes, I do not see any significant holdback other than the standards to qualify are similar to what they were prior to some of the issues we have run into. So you are required to show that you are employed and you have money in the bank and that sort of thing. So that is going back to probably when we all got our first loans or whatever.

Whether or not banks are lending money has a lot to do with whether or not they are in a position that they can due to regulatory concerns perhaps, but I think from just the mortgage lending aspect, there is plenty of credit available for those people who are qualified.

Ms. GOLDER. I would agree that the community banks are lending. That they are in the community, they are invested in the community, they want to see that money stay in the community. Each home that is sold adds $63,000 to the economy within a community. Bankers understand that. And it seems the further away a bank or savings and loan gets from the community, the less likely that they are going to be involved. So the community banks, at least where I am from, are lending.

Mrs. MCCARTHY OF NEW YORK. I want to thank everybody for their testimony. We certainly are going to look at and hopefully get this economy turned around. The housing issue is a big issue. Unfortunately, from those economists who are there, they are talking about unemployment will probably still continue to go up through 2010. That is something hopefully we can all work on here to stop because that will also stop in my opinion many of the foreclosures that we are seeing now, that a lot of people just do not realize they are one paycheck away from, unfortunately, being unemployed.

So with that, I thank you for all of your testimony and your patience on being here with us. Without objection, your written statements will be made a part of the record.

This hearing is now adjourned.

[Whereupon, at 3:45 p.m., the hearing was adjourned.]

A P P E N D I X

December 2, 2009

December 2, 2009
Statement by the Honorable Kenny Marchant
Committee on Financial Services
Hearing on "FY09 FHA Actuarial Report"

Throughout the economic turmoil created by this recession, a consistent theme I hear from my constituents day in and day out is this: no more bailouts. The actuarial report indicating the perilous state of affairs at the FHA seems to be a prelude to a bailout. This worries me very much. What I want to hear from the Secretary today is that there will not be another bailout. I am also looking forward to hearing the Secretary's plan for shoring up the fund and protecting the taxpayers.

As with several other sectors of our economy, the housing sector has been almost completely taken over by the Federal government. The majority of mortgages in this country are now being backed in some way, shape or form, by Uncle Sam. And with rising defaults coupled with an already decimated private lending industry, this puts the FHA in an unenviable position.

However I believe the proper balance can be struck between protecting taxpayers and ensuring a recovery in the housing market. The HUD Secretary already has the power to make changes that would shore up the fund, and I understand today he will ask for even more authority.

I believe the prudent course of action would be for this Congress to take measures to get private sector lending and securitization going again. In the mean time the FHA should strengthen underwriting standards and take measures to root out fraud in the system. A combination of these actions would be the best medicine for what is a very serious and pernicious problem.

I look forward to the testimony of the witnesses.

NCLR
NATIONAL COUNCIL OF LA RAZA

The Role of Federal Housing Administration Mortgage Insurance in Revitalizing Latino Homeownership

Presented at:

FY09 FHA Actuarial Report

Submitted to:

U.S. House Committee on Financial Services

Submitted by:

Janis Bowdler
Deputy Director, Wealth-Building Policy Project

NATIONAL COUNCIL OF LA RAZA
Raul Yzaguirre Building
1126 16th Street, NW
Washington, DC 20036

December 2, 2009

Good afternoon. My name is Janis Bowdler. I am the Deputy Director of the Wealth-Building Policy Project at the National Council of La Raza (NCLR). NCLR is the largest national Hispanic civil rights and advocacy organization in the United States, dedicated to improving opportunities for Hispanic Americans. I oversee our research, policy analysis, and advocacy on issues critical to building financial security in Latino communities, such as homeownership, consumer credit, auto lending, and financial counseling. During my time at NCLR, I have produced a number of publications on housing issues important to the Latino community, including *American Dream to American Reality: Creating a Fair Housing System that Works for Latinos* and *Jeopardizing Hispanic Homeownership: Predatory Practices in the Homebuying Market*. In addition, I have served as an expert witness before Congress and the Federal Reserve. I would like to thank Chairman Frank and Ranking Member Bachus for inviting us to share our views on this important topic.

NCLR is deeply concerned about the lack of progress in restoring stability and ownership opportunity to the housing market. Not only are Latino families losing their homes at record rates, but many that should be able to take advantage of the newly affordable home prices are unable to access credit. We are hearing from hardworking families from across the country wondering when they will see the effects of economic relief efforts. The Federal Housing Administration (FHA) mortgage insurance program is an important way for Congress and the administration to directly help families begin to rebuild their financial future. Nationwide, millions of families are relying on FHA to purchase their first home or help them avoid foreclosure. This is certainly true for Latino homebuyers, 45% of whom received an FHA mortgage in 2008. While the increase in claim rates against FHA's insurance fund is causing concern, the fact that FHA is fulfilling one of its primary roles in the market by stepping in to lend where others will not is essential.

For more than two decades, NCLR has advocated for policies and programs that support sustainable Hispanic homeownership. NCLR conducts research and analysis on relevant public policy issues such as preserving and strengthening the Community Reinvestment Act (CRA) and the Home Owner Equity Protection Act (HOEPA), supporting strong fair housing and fair lending laws, and expanding access to credit. In addition, NCLR is the only Department of Housing and Urban Development (HUD) housing counseling intermediary focused on the Latino community. The NCLR Homeownership Network (NHN) provided first-time homebuyer and foreclosure prevention counseling to more than 50,000 families last year alone.
NHN counselors are working closely with FHA borrowers to ensure they are prepared for homeownership and to help them avoid predatory scams.

Working families will not recover economically until jobs return to their communities and the housing market is stabilized. A robust FHA mortgage insurance program that can help guide communities of color and all families hit hard by the recession into homeownership, and maintain their investment through times of fiscal emergency, is an important government recovery tool that must be maximized. FHA has made significant strides in recent years to meet the demand of the market and respond to spikes in unemployment and foreclosures. Still, the program could be strengthened to better serve both borrowers and taxpayers.

In my testimony today, I will discuss the role of FHA in revitalizing homeownership opportunities for communities of color and others underserved by the mainstream market and provide recommendations on how to strengthen the program overall.

Federal Housing Administration

For more than 70 years, FHA has served low- and moderate-income families, often providing their only affordable loan option. During that time, FHA has repeatedly changed the face of the affordable lending market through its product innovations, such as the 30-year amortizing mortgage and low downpayment requirements. While the private market has evolved to offer more affordable products, FHA is unique in its public mission to provide homeownership opportunities to underserved communities. Over the last decade, FHA's share of the market has varied dramatically. In 2001 for example, 35% of all low- to moderate-income homebuyers, and 38% of Latinos, had an FHA-insured mortgage. In 2005, that number dropped to 13% of low- to moderate-income homebuyers and 5% of Latino buyers.[1] In the face of a severe credit crunch, lenders in search of security and liquidity returned to FHA insurance. As a result, the FHA reports that its market share shot up to 30% overall in fiscal year 2009 and 45% among Latino borrowers.

The quality of the FHA program and its ability to positively impact local conditions has also been mixed. In the 1990s, FHA came under increased scrutiny and criticism for lax oversight and accountability procedures that allowed unethical lenders to run flipping refinance scams on vulnerable borrowers and were heavily concentrated in communities of color. Some argued that the lack of oversight also permitted unaffordable mortgages, contributing to FHA's foreclosure rates being higher than conventional loans. As the program lost market share, lenders and industry stakeholders criticized the program's dated technology and processing systems. In high-cost areas, FHA's loan limits were seen as being too low for even the average-priced homes that first-time homebuyers would be seeking.

Underperformance of the FHA program has consequences for the market as a whole. When well-executed, FHA has been a benchmark by which lending to underserved communities can be measured. When it is dysfunctional, the baseline disappears. For example, the combination of challenges the FHA faces contributed to its declining market share in the first half of the decade. As the presence and influence of the FHA eroded, subprime lending skyrocketed to 40% of the market and, in many cases, replaced adequate loan products with risky and volatile substitutes. The devastating effect of toxic subprime mortgages on the housing market and broader economy is well known. Communities of color, low-income families, and first-time homebuyers—FHA's target market—have been disproportionately impacted. In 2009 alone, more than 700,000 Black and Hispanic households are expected to lose their home to foreclosure.[2] On the other hand, a strong, flexible FHA loan program can spur market innovation and provide affordable financing

---

[1] Federal Financial Institutions Examination Council, *Home Mortgage Disclosure Act (HMDA) of 1975*, "HMDA National Aggregate Report," http://www.ffiec.gov/hmdaadwebreport/NatAggWelcome.aspx (accessed November 30, 2009).

[2] Center for Responsible Lending, *Projected Foreclosures to Latinos and African Americans by State* (Durham, NC: Center for Responsible Lending, 2009).

alternatives to those of modest means. Underwriting and loss mitigation standards implemented by the FHA program are frequently adopted by other lenders and set the standard for the market.

Economic Recovery through Revitalized Homeownership Opportunities

As the economy continues to struggle and credit remains scarce, all home loan borrowers stand to benefit from a reinvigorated and assertive FHA program. With home prices dipping to new lows, many potential buyers are able to find homes in their price range for the first time. However, few are able to take advantage of the newly affordable home market because they cannot secure financing. This is certainly true for Latino families, many of whom have unique needs that the mainstream market has consistently struggled to meet. For instance, 22% of Latinos do not have enough payment information on file to create a credit score, and one in six does not have traditional banking or savings accounts. Multiple wage-earners and sources of income in a household are also common characteristics of first-time Latino homebuyers. The flexible, prime loans that once accommodated these features have nearly disappeared from the market. FHA loans have become a lifeline for local real estate markets. The importance of keeping credit flowing to communities of color and distressed neighborhoods cannot be understated. Deep-pocketed investors are moving quickly to buy homes before local residents are able to get their financing in order, shifting wealth out of neighborhoods and into the hands of absentee landlords.

An effective FHA mortgage insurance program should fill the gaps in the private home loan market through direct participation and by driving innovation in origination and loss mitigation procedures while also remaining fiscally sound. By shoring up local housing markets, the FHA program can directly contribute to the stabilization of the national economy. NCLR is encouraged by FHA's recent progress in meeting the needs of potential homebuyers and homeowners at risk of foreclosure. Notwithstanding, the recent increase in claims is an invitation to review what more can be done to strengthen the program and its underlying mission to expand homeownership and prevent home losses and, therefore, future claims. Specifically, NCLR has identified three areas that can be strengthened:

- **Lender review and enforcement.** Much of the unexpected spikes in delinquencies can be attributed to originator behaviors or economic conditions rather than the design of the FHA loan product. According to the FHA's *Annual Management Report: Fiscal Year 2009*, had loans not been made using seller downpayment assistance programs, known for being a haven for fraud and abuse, its capital reserve ratio would still be at the recommended 2%. In addition, anecdotal reports from housing counselors raise concerns that dubious brokers and lenders that once peddled predatory subprime products have turned to FHA as their primary business vehicle. FHA administrators report that more is being done to screen out bad actors, but there is little transparency in the process. It is also unclear what consequences unethical lenders face for defrauding taxpayers and the federal government and what actions have been taken. More focus should be placed on purging the list of FHA-eligible originators of unethical lenders and enforcing strong protections throughout the life of an FHA loan.

- **Innovative lending.** Successful FHA lending demonstrates how flexible home loans, underwritten according to borrower affordability, can lay the foundation for sustainable homeownership. Low downpayment requirements in particular have allowed millions of families to purchase a home and begin building wealth for their future. On the other hand, the program administrators removed a risk deterrent when they eliminated the pre-purchase counseling requirement for first-time homebuyers. In a shortsighted attempt to compete with the subprime market, administrators canceled the counseling requirement to streamline its underwriting process. To effectively serve first-time homebuyers and other vulnerable borrowers, FHA must maintain its product flexibility and maximize its opportunities to reduce risk through homeownership counseling.

- **Effective loss mitigation.** FHA has strong loss mitigation tools that have successfully kept millions of families in their home. However, these services are of little use to a family that does not receive them. While HUD mandates that servicers of FHA loans aggressively pursue loss mitigation, few resources are dedicated to enforcing this provision. Furthermore, because the mandate is not a right afforded to borrowers and there is no private right of action, individual borrowers that fall through the cracks or are overlooked by servicers have no way to defend themselves against foreclosure. HUD has the right to penalize servicers for failure to implement the loss mitigation program, yet NCLR is unaware of any attempts by HUD to exercise its enforcement power. Newly established loan modification programs, such as Making Home Affordable, have not changed this dynamic. Furthermore, the fact that claim rates are likely to remain high due to unemployment underscores the need for a broader strategy to prevent foreclosures among families that have experienced a temporary or permanent loss of income. In the cases where foreclosure is unavoidable, more can be done to ease the family's transition back into the rental market.

Recommendations

FHA is doing much to fulfill the demand for credit in underserved communities. Administrators have also stepped up their loss mitigation efforts. While economic conditions are presenting new challenges to the program, FHA administrators and policymakers cannot allow these pressures to jeopardize its social mission or shy away from deploying its resources as a recovery tool. A dynamic FHA program is critical to stabilizing the housing market and the broader economy. In that spirit, NCLR makes the following three recommendations to strengthen the FHA program, restore homeownership opportunities, and protect homeowners and taxpayers:

- **Tighten lender standards for the privilege of originating an FHA loan.** When lenders originate FHA mortgages, they borrow a brand that is backed by the full faith and credit of the federal government. Given the trust borrowers place on FHA and the exposure of taxpayers, FHA has an obligation to keep its list of eligible originators free of unscrupulous lenders. NCLR recommends that HUD institute an originator code of ethics under which all FHA originators would pledge to uphold FHA's mission and responsibilities. The code of ethics would serve as a quality control tool and should protect the integrity of the borrower-broker or borrower-lender relationship, promote transparency and prudent underwriting in the mortgage transaction, prohibit pressure sales tactics, and ensure that the borrower has access to accurate and timely information regarding their loan. The code of ethics should be coupled with more rigorous oversight and audit procedures of FHA originators and brokers and meaningful consequences for breaching the code. HUD should also employ monitoring techniques such as accepting consumer complaints, comparing the delinquency rates of lenders to their peers and the market, and interviewing FHA borrowers shortly after closing to evaluate the customer experience.

- **Establish incentives to receive pre-purchase housing counseling.** Congress has invested millions of public dollars into creating a solid housing counseling infrastructure. Families that participate in pre-purchase counseling sessions are less likely to default on their mortgage, preventing foreclosures and future claims. However, since the removal of the housing counseling requirement, fewer borrowers seek out or are informed of this free service. NCLR recommends that FHA establish an incentive in the form of premium discounts for borrowers who successfully complete one-on-one homeownership counseling from a HUD-approved counseling organization in a timely manner before the closing of their mortgage. To ensure that reliable counseling services are available to meet demand, FHA should pay counselors directly for providing advice to FHA borrowers and maintain the integrity of the nonprofit network by adopting high standards of care and professionalism.

- **Make loss mitigation accessible to all FHA borrowers.** HUD must direct greater resources into ensuring that all servicers are following the FHA servicer guidelines mandating loss mitigation. Servicers should be required to demonstrate that borrowers were ineligible for protocols or programs that could prevent the loss of the home before proceeding to foreclosure and certainly before they could file a claim. Failure to do so should be grounds for reversing a foreclosure and come with strict penalties for servicers. Furthermore, HUD should adopt a zero-tolerance policy and vigorously enforce its mandate and fine violators of the statute.

Conclusion

Hardworking families across the country are wondering when economic relief will find them. While the federal government has a number of tools at its disposal, the FHA program is one that is easier to control and should be maximized to the benefit of all families trying to break into homeownership or keep their wealth and equity from evaporating through foreclosure. For most, homeownership represents the bulk of household assets that will help families move more firmly into the middle class. A strong, competitive FHA program should support this goal, especially during a credit crunch. As private capital begins to flow again, FHA should serve as a benchmark for service to low- and moderate-income borrowers, borrowers of color, and others unable to access traditional credit.

WRITTEN TESTIMONY OF SECRETARY SHAUN DONOVAN
HEARING BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
FY09 FHA ACTUARIAL REPORT
WEDNESDAY, DECEMBER 2, 2009

Thank you, Chairman Frank and Ranking Member Bachus for this opportunity to testify on behalf of the Administration regarding the Federal Housing Administration and the steps we are taking to protect its loan portfolio as it helps to get the economy back on track at this historic moment. As you well know, the fiscal health of the FHA is essential to its effective operation. We want to ensure that we are able to continue to support the housing market in the short-term and provide access to homeownership over the long-term, while minimizing the risk to the American taxpayer.

On September 18th, we announced an initial round of policy changes to reduce risk in the FHA portfolio. With the clearer picture provided by the recent study conducted by a non-governmental independent actuary, I want to announce here today that we will be implementing additional measures that we believe will further reduce the risk to the FHA portfolio. In these measures we will be focusing primarily on three areas: enforcement, improving the quality and sustainability of new loans insured by FHA, and increasing FHA capital. I will talk a bit more about these steps later in my testimony, but first I would like to say a few words about the role that FHA is playing in the market right now, the results of the actuarial study and the reforms we've put in place thus far.

FHA: Facilitating Recovery

Created by President Franklin Roosevelt at a time when two million construction workers were out of work and housing prices had collapsed, the FHA was designed to provide affordable homeownership options to underserved American families and keep our mortgage markets afloat during tough times.

And by insuring almost 30 percent of purchases and 20 percent of refinances in the housing market, FHA is certainly doing so today.

Though I would caution that we are by no means out of the woods yet, as the National Association of Realtors reported last week, home sales have rebounded to levels not seen since February of 2007. And the S&P/Case-Shiller Home Price

Indices finds that home prices have now risen for two quarters in a row.

While there is considerable uncertainty about what these numbers mean going forward, particularly as we enter the typically-slow winter months, what is not in doubt is that the FHA has been central to much of this improvement. We know the critical role first-time homebuyers are playing in the market, including purchasing REO and vacant properties, helping stabilize home prices and communities alike. More than three-quarters of FHA's purchase-loan borrowers in 2009 are first-time homebuyers, and nearly half of all first-time buyers in the housing market in the second quarter of this year used FHA loans.

And with 51 percent of African Americans homebuyers and 45 percent of Hispanic families who purchased homes last year using FHA financing, FHA is far and away the leader in helping minorities purchase homes.

Actuarial Study

Unfortunately, FHA has not been immune to the hard times for the housing sector. With the actuarial study I cited earlier, we recently reported to Congress that FHA's secondary reserves have fallen below the required two percent level – to 0.53 percent of the total insurance-in-force. However, when combined with reserves held in the Financing Account, FHA holds more than 4.5 percent of total insurance-in-force in reserves today – $31 billion set aside specifically to cover losses over the next 30 years.

As such, the actuary concluded that FHA's reserves will remain positive under all but highly severe economic scenarios.

Further, while its secondary reserve account has been depleted too quickly, FHA is not "the next subprime" as some have suggested.

Subprime delinquencies are 240 percent higher than FHA's for a reason. While others participated in investor-owned markets or were exposed to exotic mortgages such as option-ARMs and interest-only loans, and while 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. Unlike subprime lenders, FHA requires that borrowers demonstrate they can pay their mortgage by verifying their income and employment.

All of that said, Mr. Chairman, we've learned from recent history that the market is fragile, and we have to plan for the unexpected. That uncertainty is complicated by an organization we inherited that, to be honest, was simply not properly managing or monitoring its risk.

Credit and risk controls were antiquated. Enforcement was weak. And our personnel resources and IT systems were inadequate.

Little of this may have been obvious when FHA's market share was 3 percent as recently as 2006. But when our mortgage markets collapsed last fall, and homebuyers increasingly turned to the FHA for help, the potential consequences of these lapses in risk management became very clear.

Reforms to Date

In 2008, Congress put an end to the practices that led to the most troubled loans in FHA's portfolio – so-called "Seller-Financed Downpayment Assistance" loans. Without these loans, I would note, the actuary reported that our secondary reserves would have remained above the two percent threshold.

This year, we've taken several additional steps. We've steeply increased enforcement efforts, having suspended seven lenders, including Taylor, Bean and Whitaker and withdrawn FHA-approval for 270 others, including Lend America just this week.

We've strengthened credit and risk controls – toughening requirements on our Streamlined Refinance program, making several improvements to the appraisal process and proposing a rule to increase net worth requirements for all FHA lenders. The latter has just entered the notice and comment period.

And we've hired a permanent Chief Risk Officer to provide the most comprehensive and thorough risk assessment in the organization's history – and ensure that the assumptions going into our modeling reflect the most current economic conditions.

In addition, with Congress' help, we are working to increase staffing and technical capacity and upgrade our technology systems – and though we still have a long way to go, we delivered FHA's first comprehensive technology transformation plan to Congress in September.

As significant as these reforms are, Mr. Chairman, as Senator Bond recently wrote in the *Washington Post*, these management and resource challenges are long-standing – challenges that could and should have been addressed a long time ago.

Next Steps

That is why we are drafting several new policies in FHA to address the quality of the existing portfolio, improve the performance of future books, and return the capital reserve to above the legislated 2 percent level, while also ensuring that FHA continues to contribute to the nation's housing recovery.

The actuary projects that even with growing volumes, more than 71 percent of FHA's losses over the next 5 years will come from loans already on our existing books. That's why an important step we can take to minimize losses to capital reserves in the near term is to step up enforcement and make lenders more accountable.

As such, the first set of policy changes we are proposing will focus on enforcement and lender accountability. We will step up efforts to ensure lenders assume responsibility for any losses associated with loans not underwritten to FHA standards.

We will hold lenders accountable for their origination quality and compliance with FHA policies, increasing our review of mortgagee compliance with FHA program requirements.

And we intend to expand enforcement for new loans as well. That includes requiring lenders to indemnify the FHA fund for their own failures to meet FHA requirements, and holding lenders accountable nationally for any improper activities, as we are presently limited to sanctioning individual branches.

We will also develop a Lender Scorecard that will summarize the performance of lenders who do business with the FHA. This scorecard will be posted on our website to ensure transparency and accountability for lenders, borrowers and the market.

Of course, all these steps are designed to hold lenders accountable for their origination quality and compliance with FHA policies. And as always, Ginnie Mae securities that are backed by FHA-guaranteed loans will continue to be fully covered by the full faith and credit of the U.S. government.

In addition to stepping up enforcement and accountability, which will improve the performance of both the existing and future books of business, we are committed to a series of additional steps to increase the quality of our business going forward.

An initial measure is to reduce the maximum permissible seller concession from its current 6 percent level to 3 percent, which is in line with industry norms, and we will continue to consider additional reductions. The current level exposes the FHA to excess risk by creating incentives to inflate appraised value.

Secondly, to protect the fund from the riskiest borrowers, we will for the time being also raise the minimum FICO score for new FHA borrowers.

We are currently analyzing what this floor should be, including the relationship between FICO scores and downpayments to determine whether we should increase FICO minimums in combination with changes to other underwriting criteria for lower downpayment loans.

Third, we have made the decision to exercise our authority to increase the up-front cash that a borrower has to bring to the table in an FHA-backed loan – to make sure that FHA borrowers have more "skin in the game" and a stronger equity position in their loans. There are several ways to accomplish this, and so we are currently analyzing various options to determine which is the most effective and consistent with our mission.

Finally, we are examining our mortgage insurance premium structure to determine whether an increase is needed and, if so, whether it should be the up-front premium, the annual premium or both. Our current up-front premium of 1.75 percent is below the statutory cap of 3 percent, while the annual premium is currently at the statutory maximum. To protect against future uncertainty in market conditions, we are requesting authority from Congress to raise annual premiums, as this is one of the most effective means of raising capital for the fund with the least impact per borrower.

Indeed, while most of these changes I've just described we can make on our own with no additional authority—and we expect to provide detail and public guidance for these changes by the end of January—in some cases, we will need Congress' help. In addition to asking Congress to increase the current cap on the annual mortgage insurance premium for new borrowers, we are asking for additional authority for our proposals to hold all FHA lenders responsible for their fraud or misrepresentations by indemnifying the FHA fund. We will also be asking Congress to expand FHA's ability to hold lenders accountable nationally for their performance as I mentioned earlier.

Each will require statutory support, and of course, we look forward to working with Congress closely on all these issues.

Facilitating our Recovery, But Protecting the Taxpayer

Mr. Chairman, Ranking Member Bachus, shoring up the FHA won't solve all our housing challenges – one reason the Administration is working to produce a more balanced, comprehensive national housing policy that supports homeownership and rental housing alike, providing people with the options they need to make good choices for their families.

Further, as important as the FHA is at this moment, I want to emphasize that the elevated role it is playing is temporary – a bridge to economic recovery helping to ensure that mortgage finance remains available until private capital returns.

That means that while we must remain mindful that qualified, responsible families need the continued ability to purchase a home, the changes I have announced today and those we will detail in the coming weeks will be crafted to ensure FHA steps back and facilitate the return of the private sector as soon as possible. Until the private sector can step back up, they need the FHA – and so does our housing market.

So, Mr. Chairman, while FHA must remain a key source of safe mortgage financing at a critical moment in our country's history, we recognize the risks that we face and the challenges of this temporary role that we play in today's market. And the bottom line is this: the loans FHA insures must be safe and self-sustaining for the taxpayer over the long-term. With these reforms and others we will be considering, the Administration is committed to ensuring that they are today – and into the future.

Thank you.

NATIONAL ASSOCIATION OF REALTORS®

The Voice For Real Estate®

500 New Jersey Avenue, N.W.

Washington, DC 20001 2020

Vicki Cox Golder
CRB
President

Dale A. Stinton
CAE, CPA, CMA, RCE
Chief Executive Officer

GOVERNMENT AFFAIRS
Jerry Giovaniello, Senior Vice President
Gary Weaver, Vice President
Joe Ventrone, Vice President
Jamie Gregory, Deputy Chief Lobbyist

HEARING BEFORE THE

UNITED STATE HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

ENTITLED

"FY09 FHA ACTUARIAL REPORT"

WRITTEN TESTIMONY OF

VICKI COX GOLDER, CRB

ON BEHALF OF

THE NATIONAL ASSOCIATION OF REALTORS®

DECEMBER 2, 2009

Mister Chairman, Ranking Member Bachus, and members of the Committee; my name is Vicki Cox Golder, and I am the 2010 President of the National Association of REALTORS®. I am the owner of Vicki L. Cox & Associates in Tucson, Arizona, and have been a REALTOR® for 37 years.

I am here to testify on behalf of 1.2 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the importance of the Federal Housing Administration (FHA) mortgage insurance program. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the nation's housing stock and making it available to the widest range of potential homebuyers. The Association has a long tradition of support for innovative and effective federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure federal housing programs meet their mission responsibly and efficiently.

FHA is an insurance entity within the Department of Housing and Urban Development (HUD) that provides American homeowners with safe, stable, financing in all markets. FHA is not a subprime lender, and has strong underwriting criteria to protect American taxpayers. FHA has provided access to home financing for more than 37 million American families since its inception in 1934, and has never required a federal bailout. FHA borrowers are not subsidized, and pay both upfront and annual premiums. While the program is experiencing shortfalls in its excess reserves due to our economic crisis, FHA remains financially strong and a critical part of our nation's economic recovery.

Importance of FHA

With the collapse of the private mortgage market, the importance of the Federal Housing Administration has never been more apparent. As liquidity has dried up and underwriting standards have been squeezed tight, FHA is the primary source of mortgage financing available to families today. Without FHA, many families would be unable to purchase homes and communities would suffer from continued foreclosure and blight. On September 30, 2009, the Federal Reserve published its draft explanation of the 2008 Home Mortgage Disclosure Act

(HMDA) data. That report underscores the critical role FHA is playing in the market. According to the Federal Reserve, by the end of 2008, nearly one half of home purchase loans and one quarter of refinancing loans were backed by either FHA or the VA. In addition, minority borrowers rely heavily on FHA. According to the Federal Reserve, "In 2008, more than 60 percent of home purchase loans and almost 40 percent of refinance loans to blacks were from either the FHA or VA. For Hispanic-white borrowers, nearly 50 percent of their 2008 home-purchase loans and 21 percent of their refinance loans were from the FHA or VA."[1] FHA is also the leader in serving first-time homebuyers. In FY2009, nearly 80 percent of all FHA purchases were first time home buyers, and nearly 50 percent of all first-time homebuyers used FHA financing in the second quarter of next year.

In 1934, the Federal Housing Administration was established to provide consumers an alternative during a lending crisis similar to what we face today. At that time, short-term, interest-only and balloon loans were prevalent. FHA was an innovator with the 30-year fixed rate mortgage. Once again, FHA is now the leader in providing safe, affordable financing. Many have argued that FHA is a product for low-income borrowers. In fact, FHA was created to serve the needs of all homebuyers who lacked access to mortgage financing. In FY2009, FHA loans were divided nearly equally between low, middle and high income families. The universal and consistent availability of FHA loan products is the hallmark feature of a program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity and economic downturn. FHA's portfolio grew 64 percent between FY2008 and FY2009 to $656 billion.

FHA Strength/Solvency

FHA's 2009 audit has demonstrated that its capital reserve fund has fallen below the Congressionally-mandated 2 percent ratio. The capital reserve ratio reflects the reserves available (after paying expected claims and expenses) as a percentage of the current portfolio, to address unexpected losses. While this is sobering news, it is important to recognize that this is

[1] *The 2008 HMDA Data: The Mortgage Market during a Turbulent Year*, http://www.federalreserve.gov/pubs/bulletin/2009/pdf/hmda08draft.pdf

not FHA's only reserve fund. FHA also has a cash reserve account separate from the capital reserve. Consequently, FHA's actual total reserves are higher than they have ever been with combined assets of $30.4 billion. This is an increase of 13 percent over the previous year. In fact, the audit confirms that FHA has "positive" reserves – meaning they have adequate resources to cover all claims and expenses from their portfolio. It is critical to note that FHA's fully capitalized cash reserves account for paying all claims over a 30 year period. By comparison, the Financial Accounting Standards Board only requires financial institutions to hold reserves for losses over the next 12 months. FHA has 30 times that amount in their cash reserves, with another $2.7 billion in the excess capital reserves. In addition, the audit shows that if FHA makes no changes to the way they do business today, the reserves will go back above 2 percent in the next several years.

The reason the capital reserves have fallen below 2 percent actually has nothing to do with FHA's current business activities. The decline is simply a reflection of falling value of homes in their portfolio. The economic forecaster that FHA uses to conduct its audit dramatically revised their projection of home prices from an expected increase of 2.4 percent to a loss of 10.2 percent. This significant change in assumed home price values and depreciation directly impacted the economic value of the fund. There has not been a significant increase in defaults on the part of borrowers, or underwriting problems suffered by FHA and its lenders. Instead, the decrease in the capital reserve account is a direct reflection of the state of our economy and our housing markets.

Obviously, the economic crisis our country is facing is far beyond the control of FHA. As a Congressional Research Service (CRS) report, published November 23, 2009 stated "FHA would not be able to prevent defaults arising from deteriorating financial and macroeconomic conditions."[2] Given the devastating impact home price declines have had on banks, lenders, and the government sponsored enterprises (GSEs) Freddie Mac and Fannie Mae, FHA has performed remarkably through this crisis. Why? FHA has never strayed from the sound underwriting and appropriate appraisal policies that have traditionally backed its loans. FHA has met the needs of low and moderate income homebuyers, but has never resorted to abusive loans, improper or

[2] CRS Report R40937, *The Federal Housing Administration (FHA) and Risky Lending*, coordinated by Darryl E. Getter.

nonexistent underwriting, or other bad practices. As a participant in the home mortgage process, FHA cannot be immune to the pitfalls of the housing crisis. But solid policies and practices have protected it from the biggest failures.

Today, FHA borrowers' credit profile has never been stronger. The Federal Reserve report shows that FHA is not the new subprime lender - its FICO scores have increased, and its Loan-To-Value ratios (LTVs) decreased. The average credit score for FHA's current customer has grown to 693, and only 13 percent of their purchase borrowers this year had FICO scores below 620. Forty four percent of FY2009 loans have FICO scores above 680, and 30 percent had scores above 720. And those numbers are only improving, according to HUD's recent Report to Congress. In September of this year 45 percent of FHA loans had FICO scores above 700, and less than 5 percent had scores below 620. Borrowers also have more equity, as the percentage of FHA's LTV ratios above 95 percent fell from 72 percent in 2007 to 62 percent in 2008. In fact, the audit shows a record $4.9 billion positive adjustment due to the credit quality of FHA's recent originations.

Over-reaching Changes

Some have introduced proposals that react hastily to FHA's audit findings. We urge Congress and the Administration to exercise caution before introducing proposals that may have a profound adverse impact on our economic recovery and diminish programs that serve such a critical role to our nation's families. Rep. Scott Garrett (R-NJ) has introduced H.R. 3706, the "FHA Taxpayer Protection Act of 2009". We strongly oppose this legislation. Increasing FHA's downpayment would not add a penny to FHA's reserves. While it would increase individual borrower's investment in the home, it would disenfranchise many FHA borrowers. Closing costs average 3-5 percent of the cost of a home. Those costs combined with the current 3.5 percent downpayment requirement are sufficient to insure a borrower's commitment to homeownership, and represents a significant financial burden. Requiring a larger downpayment will make homeownership out of reach for many families and for others could deplete their cash reserves for home and other emergencies.

We believe FHA is taking the necessary steps to assure its financial solvency, and that it remains a critical source of mortgage insurance for America's homebuyers at all times – good and bad.

FHA's New and Proposed Changes

While FHA is not required to do anything when the reserves fall below 2 percent, FHA is appropriately taking steps to improve its financial position. First, it has hired a Chief Risk Officer to oversee FHA's efforts to mitigate risk. This is the first time in the history of FHA that a Chief Risk Officer has been appointed. We applaud the leadership of FHA Commissioner Dave Stevens for making this decision so quickly after taking office. The Chief Risk Officer has the primary responsibility for overseeing risk management across all FHA programs. We believe FHA has taken strong measures to mitigate risk, but assigning one senior staff member with the responsibility for coordinating FHA's risk management activities makes good sense.

FHA also announced that it will modify its procedures for streamlined refinancing. For those borrowers who apply for a simple refinance loan with no cash out, FHA will now require a short seasoning period for the original FHA loan (6 payments), the lender to demonstrate a net benefit to the consumer, and the borrower to exhibit an acceptable payment history. We do not think any of these changes are onerous for consumers or lenders, and strongly admire FHA for including the "net benefit" requirement to assure consumers aren't bearing the costs of refinancing, without receiving any benefit.

In addition, lenders must verify that the borrower is employed and has income at the time they refinance an existing FHA loan into a new FHA loan. While we understand the logic of this requirement, we question what will occur in the case where a borrower is between jobs, is still making their mortgage payments, and the refinance into a lower interest rate or a different type of loan would make it easier for them to make those payments (net tangible benefit). Would those borrowers – whose risk is already borne by FHA – be ineligible for a refinance? Where the borrower will take cash out of the transaction, we support FHA's changes to require additional underwriting and property appraisals.

FHA has also released mortgagee letters on appraiser independence, effective January 1, 2010. We support FHA's guidance related to geographic competence, especially as it relates to the use of Appraisal Management Companies (AMCs). FHA does not require lenders to utilize AMCs, and reinforces the importance of geographic competence. Consumers and REALTORS® have encountered significant problems with appraisals when the appraiser is not familiar with the community in which the home is located. FHA's mortgagee letter states that lenders and appraisers are both responsible for the quality and accuracy of the appraisal. FHA states that the lender is responsible for determining whether an appraiser's qualifications are sufficient prior to assigning an appraisal. Appraisers are reminded that the Uniform Standards of Professional Appraisal Practice (USPAP) applies to all appraisals performed for properties that are security for FHA. In addition, FHA's letter states that if the lender orders an appraisal through an AMC or another third party organization, the lender must ensure that specific guidelines are followed to ensure the FHA appraiser is compensated appropriately and that the fee charged to the consumer for the appraisal report is consistent with the market rate for appraisals.

The letter also provides guidance on the subject of appraisal portability. NAR believes it is important for borrowers to have complete flexibility in choosing a lender, and should not be hampered by having to obtain a second appraisal simply because they switched lenders. NAR feels strongly that consumers should not be required to pay excessive fees for appraisals, nor be subject to appraisals conducted by appraisers who are not familiar with their market. Under the FHA's rules, mortgage brokers' and lenders' underwriting staff will be prohibited from ordering an appraisal. This will create a firewall between lending staff and the appraiser and enhance the independence of the appraisal process. To further support the independence of appraisers and to ensure uniformity in the real estate industry, we have called on FHA to work with the GSEs to establish a combined frequently asked questions (FAQ) document that will be codified in existing appraisal policies. In a recent meeting, FHA Commissioner David H. Stevens has asked his staff to begin discussions with the GSEs to further explore this recommendation. We support these changes by FHA.

FHA will also begin rulemaking addressing mortgage lender and broker net worth. They will propose to increase the net-worth requirements for mortgagees to $1 million (from $250,000) and will place liability for mortgage brokers' actions on the lenders. NAR does not have data or policy on these specific lender issues. However, such actions would put FHA in-line with industry standards, and do not appear to be particularly onerous for lenders. Assuming FHA has data to show that these changes are needed to help retain the safety and soundness of the FHA fund, we would support these proposals.

NAR Additional Recommendations for FHA

NAR advocates additional changes for FHA to ensure its continued strength and availability to homeowners.

Technology and Staffing

NAR strongly supports increased funding for FHA to upgrade its technology. FHA operates with technology that is an average of 18 years old. Quickly upgrading the dozens of incompatible systems, such as the 30 year old Common Business-Oriented Language (COBOL) system, to web based customer-centric applications is necessary for the agency's continued existence and future success. Legislation recently passed the House, H.R. 3146, the "21st Century FHA Housing Act of 2009," which would provide this authorization. This bill, introduced by Representatives Adler (D-NJ) and Lee (R-NY), will provide a number of reforms to modernize FHA. We also understand funding has been included in the Appropriations bill for HUD, and we urge that funding to be included in the final version of the FY2010 Appropriation for HUD.

We also believe HUD should have the ability to hire the professional staff needed to run what is now such a large and critical component of our housing finance system. H.R. 3146 provides HUD flexibility to hire appropriate staff using the compensation guidelines of similar agencies, such as the Federal Housing Finance Agency or the Federal Deposit Insurance Corporation. The legislation would also permit the hiring of expert consultants to work on specific program areas within FHA's operations. We think these changes are necessary to ensure the FHA is able to work efficiently and effectively with qualified, experienced staff.

Condominium Rules

NAR has also been working closely with FHA on their new condominium approval process. As originally published in Mortgagee Letter 2009-19, we have concerns that some components of the new policy may lengthen the real estate crisis, just as some markets are seeing positive growth. We applaud the Department for delaying implementation of this letter, and believe they are making some changes to their policies.

NAR recommends elimination of the owner-occupancy requirement for FHA condo mortgages. The GSEs do not have an occupancy ratio for condominium projects if the borrower is going to occupy the unit, which of course would be the case for all FHA borrowers. Eliminating this requirement will allow more buyers to purchase condominiums (which are often more affordable), raise occupancy levels, and will stabilize these developments and the community. If FHA retains the occupancy ratio, NAR recommends amending the rules so that all bank-owned REOs are not counted for the purposes of the occupancy ratio. FHA amended the rules in their temporary condominium guidance (ML 2009-46 A) but we believe this should be included as a permanent part of the owner-occupancy calculation. Again, this will align FHA with the industry practices in this area.

Condominiums are often the only affordable option for first time home buyers or borrowers with good credit, but small downpayments. NAR recommends amending the FHA concentration requirement. Currently, no more than 30 percent of the total units in a project may have an FHA mortgage. While FHA is temporarily increasing this limit to 50 percent, we believe that making the 50 percent cap permanent or increasing it further, will result in a greater owner-occupied ratio in the project because more borrowers will be able to use FHA to purchase a primary residence.

Many new condominiums remain largely vacant because of our real estate crisis. But FHA requires that at least 50 percent of the units be sold prior to FHA's endorsement on a unit.

This eliminates condominiums as an option for many FHA borrowers. FHA temporarily reduced the requirement to 30 percent. However, this reduction should be made permanent or eliminated so that the borrower has greater choice of available units.

NAR urges FHA to clarify the condominium reserve study requirements. Currently the reserve study requirement can be financially costly for small condominium associations and can cause delays in completing sales. We urge FHA to clearly state what has to be included in the study and who should conduct and bear the costs of the study.

Lastly, NAR recommends FHA reconsider the elimination of the Spot Loan Approval Process. Spot loans can be critical for borrowers who wish to use FHA to purchase a condominium in a project that is not FHA approved. While we applaud FHA for extending the Spot Loans through February 1, 2010, elimination of the Spot Loan Approval Process effectively reduces consumer choice in condominiums as there will likely be many projects not approved by FHA but a logical choice for potential homeowners.

<u>Mortgage Loan Limits</u>

We also strongly support making permanent the FHA mortgage loan limits that are currently in effect. FHA has played a critical role in providing mortgage liquidity as private financing has dried up. We applaud Congress for extending the current loan limits through 2010, but they need to be made permanent.

In today's real estate market, lowering the loan limits further restricts liquidity and makes mortgages more expensive for households nationwide. FHA and GSE mortgages together continue to constitute the vast majority of home financing availability today, which makes it particularly critical to extend the current limits. Without the additional liquidity created by maintaining these loan limits at current levels, families will have to pay more to purchase homes, face the possibility that they will not be able to obtain financing at any price or find it more difficult or impossible to refinance problematic loans into safer, more affordable mortgages.

Many argue that the loan limit increases help only the higher cost areas, but this is not the case. According to a recent HUD report, only 3 percent of FHA loans are above $362,750, and less than 2 percent are above $417,000. But decreasing the loan limits would impact 612 counties in 40 states plus the District of Columbia. The average decline in limits would be more than $50,000. This decline would have a dramatic impact on liquidity in these markets, and could halt the housing recovery. In addition, higher balance FHA loans perform better than lower balance ones. According to the FY 2009 audit, "FHA experience indicates that larger houses tend to perform better compared with smaller houses in the same geographical area, all else being equal."[3] So despite arguments that FHA higher limits put taxpayers at risk, these loans actually add strength to the program, and reduce risk to the fund.

We strongly support the legislation introduced by Committee members Brad Sherman (D-CA) and Gary Miller (R-CA), H.R. 2483, the "Increasing Homeownership Opportunities Act" to make the current loan limits permanent. We urge the Committee quickly consider this important legislation to ensure that liquidity in this tenuous market is not put at risk.

Conclusion

The National Association of REALTORS® believes in the importance of the FHA mortgage insurance program and believes FHA has shown tremendous leadership and strength during the current crisis. Due to solid underwriting requirements and responsible lending practices, FHA has avoided the brunt of defaults and foreclosures facing the private mortgage lending industry. We applaud FHA for continuing to serve the needs of hardworking American families who wish to purchase a home.

We believe the Administration is taking appropriate and expedient steps to maintain a prominent source of homeownership financing in today's economy. We wholeheartedly support the FHA program and we stand ready to work with Congress to enhance FHA's mission, service

[3] *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund (Excluding HECMs)for Fiscal Year 2009*, by Integrated Financial Engineering Inc., November 6, 2009, pg 45.

and purpose. We thank you for this opportunity to testify, and look forward to working with you to accomplish our recommended proposals.

Testimony to
US House of Representatives
The Committee on Financial Services
on the
FY09 FHA Actuarial Report

By

Ann B. Schnare, PhD
Empiris LLC

December 2, 2009

Good morning. I would like to thank the Chairman and Ranking Member for inviting me to speak here today. My name is Ann Schnare, and I am a partner at Empiris LLC, an economic consulting firm. I worked at Freddie Mac from 1993 to 2000, first as Vice President for Housing Economics and Financial Research, then as Senior Vice President for Corporate Relations. Over the years, I have consulted on a number of issues involving FHA, including its financial health. Last year, my colleague Michael Goldberg and I correctly predicted that the Fund would fall below the 2 percent capital threshold by the end of the FY2009.[1]

Let me begin by emphasizing that FHA is playing a critical role in the housing market today. Without its continued presence, the anemic housing recovery would undoubtedly come to a halt, which would have ripple effects on the broader economy.

At the same time, there are clear indications that FHA is under considerable stress, and may in fact be laying the seeds for additional problems going forward. FHA delinquencies continue to rise; the concentration of loans in troubled markets such as California, Nevada and Florida continues to grow; and many FHA mortgages continue to be funded at effective loan-to-value ratios that are close to 100 percent. While FICO scores are also rising, high FICO scores no longer provide the protection that they once did, particularly in an economy with declining housing prices and a 10 percent unemployment rate.

The recently released FHA audit found that the Mutual Mortgage Insurance Fund has run through most of its capital reserves, and no longer meets its mandatory 2 percent threshold. Under the audit's "base case" projections, the capital ratio would be about 0.5 percent—which, given the complexity of the calculations, is effectively zero. Under more pessimistic economic assumptions, the Fund would not have the capital required to meet its projected obligations. Although we have not attempted to replicate the FY2009

[1] Michael Goldberg and Ann B. Schnare, "An Update on the Capital Adequacy of the FHA Single Family Insurance Program," February 9, 2009.

audit, in my view, the base case projections are optimistic, and the Fund is most likely facing a significant capital shortfall.

One of the major shortcomings of the HUD audit is that it does not consider the current delinquency status of loans in projecting their future performance. While this may have been a reasonable simplification in earlier years, the fragile nature of the housing market makes this omission troublesome today.

Mortgage delinquencies have been rising more rapidly than foreclosures for quite some time, creating what some believe is a "foreclosure overhang." A recent report by Amherst Securities found that although the time to foreclosure is lengthening, ultimate cure rates are on the decline—hence, the build up in the number of delinquent loans in the current inventory.[2] Since HUD's analysis bases its projections on claims, as opposed to delinquencies, it may be underestimating future losses in its book.

For example, the actuarial analysis projects that roughly 116,000 loans will default in FY2010. Yet, as pointed out by my colleague Michael Goldberg, there are already about 108,000 FHA loans that are in the foreclosure process, and new foreclosure starts have been averaging about 11,000 per month. Unless one assumes that a high percentage of these loans will cure—which seems highly unlikely—the claim rates projected in the base case would appear to be far too low. In fact, most analysts believe that the overwhelming majority of the loans that are more than 90 days delinquent today will ultimately result in a claim—an assumption that would dramatically change the financial projections for the Fund.

While cure rates can obviously be affected by many factors—e.g., future housing prices, employment trends, and loan modification programs—these data suggest that the FHA is at best running on empty and probably has crossed the line into insolvency.

[2]Laurie Goodman, Outlook For The Housing Market in 2010, Amherst Securities, November 2009

The audit may also understate the impact of the changing geographic distribution of FHA loans. HUD models future house price trends at the national level. In our earlier analysis, we projected housing prices at the metropolitan level, which helped to explain our more pessimistic projections of future performance. Given the rising concentration of loans in troubled markets such as California, HUD's approach may be underestimating both the incidence and severity of future losses.

Finally, the economic assumptions that underpin the audit may prove to be overly optimistic, particularly as they relate to house price trends in 2011 and beyond.

Recommendations

In the short-term, I believe that there are at least four things that FHA can and should do to improve the current situation.

The first is to make the financial condition of the FHA program more transparent. Waiting another year for the next FHA audit is unacceptable in this volatile economic environment. Projections should be updated on a quarterly basis to reflect changing economic conditions and forecasts. FHA also needs to provide more meaningful reports on the on-going performance of its loans. Right now, the costs of obtaining the information required for an independent assessment of the likely performance of the FHA book are far too high. Better reporting on the risk characteristics and performance of its loans should become a priority for FHA, and the reports should be made available to the public. If nothing else, such disclosure will help to calm the fears of many observers who worry that FHA is assuming too much risk.

Second, FHA should increase its downpayment requirements, particularly in markets which are continuing to suffer house price declines. While FHA borrowers are required to put 3.5 percent down, they are also allowed to finance the up-front premium and a portion of their closing costs. The net result is that many FHA borrowers are in a zero or even negative equity position the moment they move into their homes. This dramatically increases the risk of foreclosure, particularly in a bad economic environment and a weak or declining housing market.

One thing we've learned from the current crisis is that relaxed underwriting can be bad for borrowers and destroy neighborhoods. Does it really make sense to originate 100 percent LTV loans in markets with declining housing prices? FHA needs to tighten its underwriting standards to ensure that its loans perform.

Third, FHA should begin to recapitalize the Fund by enacting a modest increase in its insurance premiums. In my view, increasing the up-front premium is not the way to go. Since the up-front premium is non-refundable, this would tend to penalize borrowers who may have to move as a result of a change in job or family status. If the up-front premium is financed, it would also reduce the borrower's equity in the home. As a result, I believe that recapitalization should be accomplished through an increase in the annual premium.

When we looked at the issue a year ago, we found that a 20 to 25 basis point (bps) increase in the premium would have allowed the Fund to meet its statutory capital requirement in FY2009. While we have not updated our analysis, we believe that something along these lines would be appropriate today. The path is admittedly difficult—a large increase could defeat the purpose and lead to further house price declines. However, current FHA pricing is out of sync with that available through the GSEs and private mortgage insurers, and needs to be re-examined.

Fourth, FHA needs to audit every loan that defaults within the first 12 months. Such "early payment defaults" typically stem from shoddy underwriting practices or outright fraud. Rather than routinely paying the claims, FHA should take steps to ensure that all applicable guidelines have been met, and crack down on offending lenders. The number of FHA originators has increased dramatically in the past two years, and there are anecdotal reports that many subprime brokers have simply switched their outlet to FHA, bringing their fraudulent practices with them. The provisions contained in HR 3146 are an important step in the right direction.

Finally, in the longer term, the role and structure of FHA needs to be reconsidered within the broader context of financial reform. FHA has long been plagued by resource constraints, an inability to attract and maintain qualified staff, and lack of autonomy. Its activities and practices are not subject to the same level of scrutiny as the GSEs, although the risks it assumes are as great, if not greater. Going forward, it is critical to give FHA the resources, flexibility and oversight that it needs to accomplish its public purpose while maintaining the integrity of the Fund. FHA's role in relationship to the GSEs also needs to be reconsidered.

Fortunately, while the stakes are high, I believe we have the right people in place to guide FHA through these difficult times. Both Secretary Donovan and Commissioner Stevens understand the housing market and the mortgage business. They have already taken steps to improve risk management controls and return to quality underwriting, for example, by appointing a Chief Credit Risk Officer and increasing capital requirements for loan originators. These actions should be applauded. However, they are the beginning, not the end. I sincerely believe that if we wait another year for FHA's next financial "check-up," the results could prove disastrous.

In closing, I would like to again thank you for inviting me to this hearing today, and giving me an opportunity chance to express my views. I am a long-time supporter of both FHA and affordable lending. I hope that my comments can make a positive contribution to your deliberations.

MORTGAGE BANKERS ASSOCIATION
Investing in communities

Testimony of Robert E. Story, Jr., CMB

Chairman

Mortgage Bankers Association

Before the

House Committee on Financial Services

Hearing on

"The Federal Housing Administration's Fiscal Year 2009 Actuarial Report"

December 2, 2009

Chairman Frank, Ranking Member Bachus and members of the committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA)[1] on the Federal Housing Administration's (FHA) Fiscal Year 2009 Actuarial Report ("Actuarial Report"). I am Robert Story, Jr., President and Chief Executive Officer of Seattle Financial Group, and the Chairman of MBA.

FHA is especially important to segments of the population who need a little extra help to achieve the American dream of homeownership. More than any other nationally available program, FHA focuses on the needs of first-time, minority, and low- and moderate-income borrowers. According to recent data provided by the Department of Housing and Urban Development (HUD), both first-time homebuyers and minorities continue to make up a significant portion of FHA's customer base. As of August 2009, approximately 78 percent of FHA-insured home purchase loans were made to first-time homebuyers, and 30 percent were made to minorities. Minorities also comprise a higher percentage of the FHA market than the conventional mortgage market.

MBA has always been a proponent for a strong and vibrant FHA. We called for updates and enhancements to FHA's risk management, scope and operations well before the current market disruptions reestablished FHA's prominence as a catalyst for bringing liquidity to the housing finance system. With the increased growth of FHA and the need to protect the Mutual Mortgage Insurance Fund ("MMI Fund"), it is imperative that we move swiftly and take appropriate measures now to protect the safety and soundness of the agency. Protecting and improving FHA requires a multifaceted approach: ensuring that FHA has the right resources; requiring high eligibility standards for lenders; creating credit policies that are both prudent and aligned with FHA's mission; and ensuring that FHA is helping to provide market liquidity during times of crisis. In support of these goals, we recommend measures such as raising net worth requirements for FHA-approved lenders, reevaluating credit and underwriting standards, reexamining the insurance premium structure, and establishing sensible consumer and lender protections for Home Equity Conversion Mortgages (HECM). MBA believes these actions will not only help FHA face current market challenges, but also ensure the agency's future viability.

MBA wants to take this opportunity to thank the committee for its support of two very important policies that will help FHA continue to provide market liquidity and bring back the housing market: extending the higher FHA loan limits and extending and expanding the homebuyer tax credit. Currently, FHA, Ginnie Mae and the GSEs are the only

[1]The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

significant sources of housing finance liquidity. It is imperative that these entities provide secondary market support to as broad a spectrum of homes as possible during this period of market instability and beyond. The homebuyer tax credit, along with lower mortgage interest rates, has helped to moderate the decline in home prices by stimulating demand. With the expansion of the credit to include more borrowers, we believe this initiative will have an even greater impact on the housing market.

On November 12, 2009, FHA released the Actuarial Report. The report showed that the capital reserve account of the MMI Fund had fallen well below the two percent statutory target. In fact, it had fallen dramatically from three percent in 2008 to 0.53 percent in 2009. The announced shortfall in the capital reserve account was a major wake-up call for FHA and the lending community but not a reason to panic. The two percent target was established by Congress in order to ensure that FHA could stand the stress of a major housing and mortgage market event, an event like the one the industry is facing today. Despite the drop in the reserve account, HUD leadership has stated that FHA will not need taxpayer assistance to continue to operate.

The significant drop in the MMI Fund does, however, add urgency to MBA's efforts to evaluate and make recommendations to strengthen risk-management at FHA. Now is the time to make reasonable management decisions to protect the MMI Fund, while allowing FHA to continue to support the housing market. FHA's volume historically has been countercyclical: when the private market is under stress, FHA's volume increases as a way to fill the void, as is happening today. MBA applauds Commissioner Stevens' recent efforts to improve FHA's risk management, including hiring a Chief Risk Officer and reevaluating a number of existing polices.

However, we know that the agency will need to take further action to bring capital reserves promptly back to the two percent level. There are several options to protect the MMI Fund, including moving to a risk-based premium structure, increasing the upfront insurance premium, tightening credit guidelines, or a combination of these approaches. There are clearly pros and cons to each option, and, depending on the details, MBA is open to supporting any of these options or a combination thereof.

An example of the association's commitment to FHA is the creation of the MBA Council on the Future of FHA. This executive-level task force, comprised of lenders from small and large companies, is dedicated to assessing policy options for both singlefamily and multi-family programs and to making recommendations on how best to sustain FHA. Our short-term recommendations will focus on protecting the MMI Fund and helping the agency through this market crisis, while our long-term recommendations will focus on how to use this crisis as an opportunity to make meaningful structural changes to FHA that will permanently improve its programs. We look forward to sharing these recommendations with you in the coming months.

FY 2009 FHA Actuarial Report
The Actuarial Report provides an assessment of the fiscal health of FHA and its financial outlook. These reports provide a snapshot of the FHA portfolio at a particular point in time, which in this case was September 30, 2009. As expected, the capital reserve ratio of the MMI Fund has dropped below the minimum target of two percent. Given that the country just went through one of its greatest recessions, it is not surprising that FHA loans, and every other type of loan, are becoming delinquent and entering foreclosure at higher rates, as the unemployment rate continues to rise. Clearly, macroeconomic factors are weighing heavily on the defaults of the MMI Fund. The country's high unemployment rate, a significant depreciation in house values, and increased foreclosures are affecting many sectors of this economy.

Highlights of the Actuarial Report include:

- The capital reserve ratio as of September 30, 2009, was at 0.53 percent. In 2008, the ratio was three percent. The capital reserve ratio measures *excess* reserves beyond forecasted net claim costs on outstanding loans.

- The combined FHA capital reserve and finance accounts equal $31 billion in total reserves, or about 4.5 percent of the agency's total insurance-in-force.

- During the last fiscal year, FHA guaranteed more than $360 billion in single-family mortgages, a 75 percent increase over FY 2008 activity.

- Under most economic scenarios, FHA's total reserves remain above zero. A key factor to how quickly reserves will grow is the stability of home prices.

- The MMI Fund is greatly impacted by the performance of seller-funded downpayment assistance loans. Claim rates for these loans are two to three times higher than other FHA loans. An additional $10.4 billion in losses is expected to occur as a result of these loans. It should be noted that, according to the Actuarial Report, FHA would have achieved the two percent capital ratio if seller-funded downpayment assistance loans were excluded from the audit. Congress prohibited these types of loans in 2008 through the passage of the Housing and Economic Recovery Act of 2008 (HERA).

Recent Changes in FHA Borrowers and FHA's Book of Business
MBA has reviewed the audits of the HECM and non-HECM portions of the MMI Fund. These audits used a wealth of data, sophisticated use of industry standard modeling techniques, and reasonable assumptions regarding potential economic environments that could impact the capital adequacy of the MMI Fund. Clearly, different choices of model specifications or economic assumptions might have led to somewhat different results, but these audits appear to have been conducted carefully and professionally, and hence are a valid basis for the important public policy discussion regarding FHA in which we are now engaged.

For a private sector financial institution, regulatory capital measures are a key measure of financial health. Banks and other financial institutions set aside reserves to cover expected losses on lending but also hold capital to cover unexpected losses that may arise from changes in economic or financial market conditions or loan performance. Regulators require financial institutions to hold sufficient capital to minimize the likelihood that they would become insolvent during a crisis. FHA's capital adequacy requirements are designed to be analogous to those for private institutions – they minimize the likelihood that taxpayers would need to provide funds to FHA.

The Actuarial Report raises a number of MMI Fund performance issues of concern to MBA. These concerns underscore the need for increased risk management at FHA. A summary of these concerns is below:

- Industry standard models predict that the FHA combination of low downpayments and lower credit scores could lead to default rates that are significantly higher than loans with higher downpayments and better credit. Because of this projection, we believe a reexamination of FHA's minimum borrower credit requirements is warranted.

- At any time, it is difficult to accurately estimate expected credit losses on a portfolio. It is particularly difficult to estimate expected credit losses on the FHA portfolio (given its relatively high level of risk) under these market conditions. For that reason, we encourage FHA to make immediate programmatic changes that would replenish the capital reserve account to cover potentially large unexpected losses, without compromising the agency's mission.

- As FHA has entered new segments of the market, particularly expanding the share of its business in certain geographic areas, the uncertainty regarding these estimates increases. The average FHA loan size is less than $200,000, but FHA is making loans up to $729,750 in high-cost areas. Even though many of these loans are to higher credit score borrowers, there is the potential for much larger losses due to higher balance loans.

- Conventional-to-FHA refinances are a major source of the new business from high-cost markets. The impact is a better credit profile, but such refinances introduce new risks as these are areas of the country where FHA has limited history.

- The seller-funded downpayment assistance program is clearly responsible for a large portion of the expected losses on the current book. Fortunately, Congress ended this program in 2008, but this situation underscores why FHA needs the flexibility to make quick, independent programmatic adjustments in response to market changes or to problems within a program. Additionally, FHA, Congress, and the industry need to carefully evaluate FHA's current risk posture to prevent similar programs from consuming such a disproportionate share of resources in the future.

- Some of FHA's underwriting criteria raise concerns. From January through August 2009, 86 percent of FHA purchase loans had loan-to-value (LTV) ratios of 96 or higher. Approximately 87 percent of FHA refinance loans had LTV ratios above 80. FHA loans also are underwritten to higher ratios than conventional loans. While conventional loans typically are limited to front-end (mortgage payment/income) ratios of 28 percent and back-end (total debt/income) ratios of 36 percent, FHA ratios allow borrowers to have ratios of 29 and 41 percent respectively. Again, the quality of FHA originations has improved in recent years, primarily due to the inflow of borrowers who do not have other financing options.

While we have the concerns listed above about the MMI Fund, we should also note several features of FHA lending that mitigate risks and may help improve future performance. FHA's loan volume has soared in recent years – increasing from approximately three percent of the market in 2006 to approximately 30 percent in 2009 – due to the contraction of the private market. With this increase has come a change in FHA portfolio composition. Changes in borrower and loan profiles and geographic distribution have played significant factors in what the FHA book of business looks like now and how we can expect it to perform in the upcoming years. Highlights of these trends are noted below:

- The quality of FHA originations has improved in recent years, primarily due to the inflow of borrowers who do not have other financing options. In FY 2009, 44 percent of FHA loans had credit scores above 680, compared to just 25 percent in FY 2008 and 19 percent in FY 2007. In 2009, the average credit score of new borrowers reached 690. Additionally, 30 percent of the FY 2009 loans had credit scores above 720, compared to 16 percent in FY 2008 and ten percent in FY 2007. Importantly, there has been a decline in the percentage of credit scores below 620. In FY 2009, 13 percent of FHA loans had credit scores below 620, versus 34 percent in 2008 and 47 percent in FY 2007. These statistics show that although FHA volume is increasing, borrower credit is improving.

- FHA's adjustable rate mortgage (ARM) share has always been quite low: typically only one to two percent. Fixed-rate loans tend to have lower default risk than ARMs. FHA also requires full documentation on the majority of its loans. (The exception is its streamlined refinance program, which refinances a borrower from one FHA loan to another. It should be noted that FHA recently tightened the guidelines for this program in an effort to better manage risk). This requirement substantially reduces credit risk. Standard and Poor's estimates that credit losses on no doc loans average six times higher than those on full doc loans.

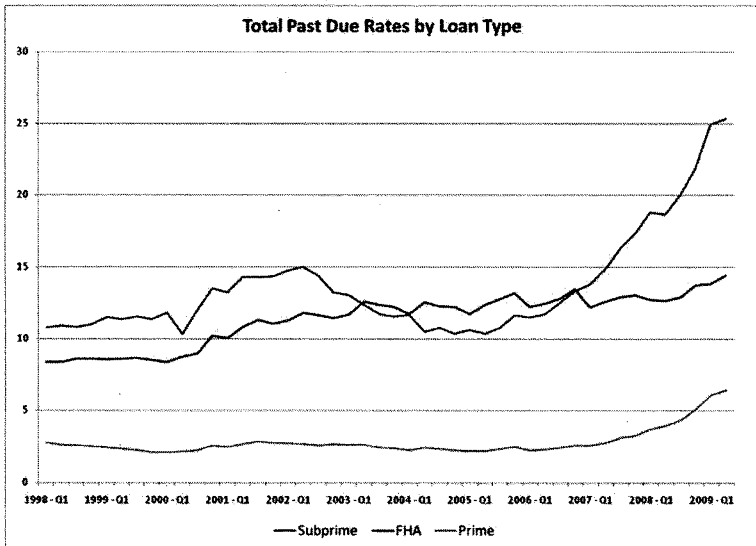
- The influx of new business also has altered the geographical composition of the FHA portfolio in several notable respects. FHA has typically had a much larger presence in lower cost markets across the country, particularly in Midwestern and Southern states. Until recently, FHA played a very small role in the higher cost coastal states. For example, FHA used to do just two percent of its business in California. This year, it is doing 12 percent. This geographical distribution has helped FHA weather the current economic storm because it insured so few loans in some of the locations that have been plagued by a high foreclosure rate due to overbuilding and a severe decline in home values.

- Despite this new business, FHA remains an extremely important source of financing for first-time homebuyers. First-time homebuyers have accounted for 76 to almost 80 percent of all FHA purchase applications in the past two years. By comparison, in the broader market, first-time buyers typically account for about 40 percent of home purchases.

- FHA has also always been an important source of financing for minority home buyers. Minorities account for approximately 25 percent of FHA purchase loans and about 30 percent of FHA first-time home buyer loans. These shares have decreased slightly in the past two years as more non-minority borrowers have turned to FHA.

- FHA refinance business has also increased, thus helping existing borrowers lower their monthly mortgage payment and bringing new borrowers to FHA. In FY 2009, FHA insured approximately 20 percent of total refinances in the housing market. Access to FHA financing has substantially helped borrowers seeking to refinance into what are historically low mortgage rates. In fact, not only have homeowners with FHA loans been able to refinance, but, in many months, a larger number of homeowners with conventional loans have been able to refinance through FHA. For these homeowners, lower monthly payments are a tremendous benefit during difficult economic times.

<u>MBA's National Delinquency Survey</u>
Given this profile of FHA business, particularly the mix of risk characteristics, one would expect FHA loans to have higher delinquency and foreclosure rates than prime loans, but lower than subprime loans. In fact, that is what the historical data from MBA's National Delinquency Survey (NDS) has shown, with some important exceptions.



As shown in the chart above, from 1998 through 2002, total past due rates on FHA loans tended to track between those on prime and subprime loans. From 2003 to 2007, delinquency rates on FHA loans were actually higher than those on subprime loans, but this was primarily due to FHA's declining market share – a shrinking denominator increased the reported delinquency rate. From 2007 to the present, the opposite is at work. FHA's book is growing rapidly – the number of FHA loans outstanding has increased by about 1.1 million over the last year – and as a result the denominator is growing faster than delinquencies are rising, pushing down the reported delinquency rate. Similar dynamics are operating with respect to FHA's foreclosure rate.

According to MBA's Q3 2009 NDS, the delinquency rate for FHA loans increased 134 basis points this quarter (from 13.70 percent to 15.04 percent), and has increased 144 basis points relative to last year. FHA's foreclosure starts rate increased 16 basis points this quarter (from 1.15 percent to 1.31 percent), and has increased 36 basis points over the past year. The foreclosure rate on FHA loans increased, despite having a large increase in the number of FHA-insured loans outstanding. If we assume these newly-originated loans are not the ones defaulting and remove the big denominator increase from the calculation results, the foreclosure rate would be 1.76 percent rather than 1.31 percent reported.

An analysis of the Actuarial Report and NDS indicates that there are significant risks in the MMI Fund, but there also are encouraging signs that point to a promising FHA future. MBA would like to reiterate its support for various programs and policies that we believe are crucial to the long-term sustainability of FHA and the housing market.

Resources Necessary for Improved FHA Operations
MBA believes a critical requirement for achieving, sustaining and protecting the housing market's long-term vigor is ensuring that FHA has the resources it needs to operate in a modern, high-tech real estate finance industry. FHA's staff levels have remained virtually unchanged, even though its market share has risen from three to over 30 percent. This ratio of activity to resources is unsustainable because it stretches FHA beyond its capacity. MBA strongly supports H.R. 3146, the 21st Century FHA Housing Act, which would provide FHA with up to $72 million in funding to hire additional staff and upgrade compensation to be commensurate with that of other federal financial regulators. The bill also permits funding to upgrade technology. Modern technology would enable FHA to better monitor lenders, protect against fraud, and generally be better equipped to handle the challenges of a modern marketplace.

MBA is grateful that, in HERA, Congress authorized $25 million to be allocated each year from FY 2009 through 2013 to provide FHA with improved technology and processes and to help reduce mortgage fraud. The Omnibus Appropriations Act of 2009[2] made $4 million available for FY 2009 and FY 2010 to be used "for planning, modernizing, improving and maintaining information technology applications and infrastructure supporting FHA." While this funding is appreciated, it is not nearly enough to address FHA's growing needs. We urge Congress to provide the full $25 million each fiscal year though 2013, as authorized under HERA. Furthermore, as in H.R. 3146, FHA should be given the statutory authority to use its future revenues to make technology upgrades as needed. Ensuring these resources are available to FHA not only helps support the viability of its products and services, but it also helps protect the MMI Fund and the American taxpayer.

Recent FHA Credit Policy Changes
Given the growth in its market share, and the potential risk to its finances, it was prudent for Commissioner Stevens to make recent policy changes to the FHA program. MBA supports the direction of these changes and expects to work closely with FHA to implement additional adjustments that will help put the agency on a stronger financial footing.

Appraisals

As MBA stated in previous testimony, reliable and accurate collateral valuations are important tools to help FHA, lenders, and investors estimate their risk of loss in a home purchase or refinance transaction. Determining a property's value is not an exact science, and it is even more difficult in markets where home prices are volatile or declining. As a method of promoting reliable and accurate appraisal practices, FHA-

[2] Pub. L. 111-8 (March 10, 2009).

approved lenders are required to use certified appraisers listed on FHA's Appraiser Roster.

MBA members continue to express concern regarding the ambiguity of various terms of the Fannie Mae and Freddie Mac (the GSEs) Home Valuation Code of Conduct (HVCC), and we have undertaken several initiatives to obtain clarifying interpretations from the drafting parties: the GSEs, Federal Housing Finance Agency and New York Attorney General. We understand the guidance recently issued by FHA was an attempt to refine several of the more contentious HVCC terms, such as permissible communications with appraisers and appraisal portability. MBA appreciates FHA's proactive attempt to add the agency's perspective in these areas. We also recognize that the HVCC is just one component of the supervisory framework governing appraisal practices, which also includes the Uniform Standards of Professional Appraisal Practices (USPAP) and other interagency guidance of the federal financial institution regulators. We are committed to working with all of these regulatory bodies to ensure that property valuations are reliably prepared by qualified professionals in an environment free from coercion.

Revised Streamline Refinance Transactions

FHA's refinance transactions are meant to allow borrowers to pay off an existing loan and refinance into one that offers a better financial option. Recently, some borrowers have been using streamline refinances as a loss mitigation tool, which is an improper use of the product. MBA supports the direction of the changes that FHA made to its streamline refinance program. Verifying documentation, determining net tangible benefit, and obtaining credit scores, when available, are all sound underwriting practices that MBA supports.

Net Worth Requirements and Modification of Mortgagee Approval Process

As a government housing finance program, FHA deserves, and borrowers should expect, exceptional quality standards. FHA-approved lenders and correspondents (mortgage brokers) should be held to the highest levels of accountability, knowledge and professionalism. For these reasons, MBA recommends raising FHA's existing qualification standards.

One area where FHA should consider enhancing its quality controls is by setting higher net worth and bonding requirements for single-family mortgage correspondents and bankers to participate in the program. Such net worth requirements would better hold lenders and correspondents accountable for their actions.

FHA also is proposing to modify the mortgagee approval process, thus eliminating the requirement for loan correspondents to receive independent FHA approval for origination eligibility. The FHA-approved mortgagee would then assume the responsibility and liability for the loans underwritten and closed by the broker.

According to FHA, this policy change is necessary because the agency does not have the resources to effectively manage and monitor the broker community. The shift in responsibility also aligns its policies with those of the GSEs. MBA agrees that FHA staff is stretched thin and requires additional resources to develop and implement quality control mechanisms and we are considering FHA's proposal, as well as other suggestions. Regardless of whether we ultimately support the proposed approval process, MBA believes FHA should establish a minimum net worth requirement for brokers because it is important to have a uniform standard to promote consistent quality and a level playing field.

As both of these changes must be done through the rulemaking process, MBA will provide extensive comments once the details of HUD's proposal are known.

Home Equity Conversion Mortgage Program

Home Equity Conversion Mortgages are designed to help one of our most vulnerable populations, seniors, so it is critical that care be taken to prevent abuses. In an effort to be proactive in this area, MBA convened an executive-level task force last year that created a reverse mortgage model bill for states. This model bill would protect both consumers and lenders and would offer a unified approach to these policies across states. Most of our recommendations were modeled after FHA's existing HECM policies. MBA is firm in its support for mandatory counseling for all reverse mortgage borrowers, as well as preventing cross-selling as a condition for receiving a reverse mortgage.

This year, for the first time, FHA requested a subsidy of $798 million as part of the President's FY 2010 budget, to cover losses that might be incurred over the life of the loans originated in FY 2010. The House version of the appropriations bill did not include any subsidy, while the Senate version included a subsidy of $288 million. These two bills are currently in conference. In the meantime, it became clear that FHA needed to re-evaluate the HECM program. This evaluation led to the recently-announced change to the principal limit factors that became effective October 1, 2009. This change resulted in a 10 percent reduction to the principal limit. Although MBA understands the business rationale for this change from a risk perspective, it is critical to note that it is the consumers who are being negatively impacted because they are receiving lower proceeds for the same cost. MBA also objects to the short implementation time for such a significant policy change.

Some of the other choices for addressing the HECM shortfall include Congress appropriating a subsidy, FHA changing the upfront premium, or FHA reducing the HECM loan limit. MBA does not support a reduction in the existing loan limit. We are working with FHA and other industry groups to recommend a long-term solution that would keep the HECM program self-sustaining.

FHA Multifamily Programs
With all of the focus on the residential real estate market, MBA must point out the continued – and even expanded – importance of FHA's multifamily programs in today's housing market.

During the current market downturn, affordable rental housing becomes a more urgent need for families and elderly individuals who either cannot afford to buy or who chose to rent. With the collapse of the commercial mortgage backed securities (CMBS) market, FHA is experiencing a significant increase in volume in its multifamily and healthcare programs. During FY 2008, FHA issued commitments for $3.4 billion in multifamily/healthcare mortgages. In FY 2009, FHA issued commitments for $5.1 billion, a more than 50 percent increase, and these numbers do not reflect substantial waiting lists for applications whose reviews were delayed into FY 2010 because of limited FHA staff capacity.

FHA's multifamily and healthcare programs are extremely staff-intensive, as each application must be thoroughly reviewed and approved by FHA staff prior to the issuance of a commitment. The need for additional staff and enhanced technology are as critical for these programs as they are for the single family programs.

MBA also wants to commend the House for passing H.R. 3527, the FHA Multifamily Loan Limit Adjustment Act, in September. While FHA's multifamily loan limits are sufficiently high in most markets, in some areas of the country they are severely restricting the ability to use FHA insurance programs to finance rental housing. H.R. 3527 will increase the loan limits for elevator buildings and provide the HUD Secretary with additional discretion in extremely high-cost areas (similar to that provided in Alaska and Hawaii today).

Conclusion
Thank you for the opportunity to testify. The U.S. and world economies are just beginning to recover from what has been one of the most severe economic downturns in 70 years. To some extent, it makes sense that both private and public institutions have depleted their capital resources during this period -- this is the stress test. Nevertheless, it is important to take this time to prudently, but quickly, evaluate how to strengthen an agency like FHA's resources for the future. Hasty policy decisions could do more harm than good. MBA appreciates all that FHA is doing to provide stability, liquidity and affordability during this difficult time in the housing finance market – it is performing its countercyclical role as intended. MBA stands ready to work with Congress to enhance and sustain FHA now and in the future.

Amherst Mortgage Insight

Amherst® Securities Group LP

November 23, 2009

MBS Strategy Group
Laurie Goodman / lgoodman@asglp.com / 212.593.6026
Roger Ashworth / rashworth@asglp.com / 212.593.6095
Brian Landy, CFA / blandy@asglp.com / 212.593.6094
Ke Yin / kyin@asglp.com / 212.593.6093

Negative Equity Trumps Unemployment in Predicting Defaults

Summary

In this article, we show that negative equity alone is a more important predictor of defaults than unemployment. We also establish that when the borrower is significantly underwater, high unemployment can act as a trigger, amplifying the level of defaults.

The big question in the mortgage market is—

Will the next wave of defaults be driven more by unemployment or by negative equity?

This is very important, because policy prescriptions differ substantially based on the response. If defaults will be *unemployment* driven—one would address that directly, perhaps through a subsidization of mortgage payments. But if the next default wave will be driven by *negative equity*—it makes more sense to apply a combination of policies designed to curb further home price depreciation. This latter avenue includes limiting the supply of homes for sale by improving the success of modification programs. However, to boost success rates on modifications, the borrower must be re-equified. This means, when doing a modification, principal reduction must be placed higher in the cash flow waterfall.

In this article, we show that negative equity is a far more important predictor of defaults than unemployment. We present 2 pieces of evidence. The first is *timing*—default transition rates picked up long before unemployment picked up—thus unemployment did not "cause" defaults. The second is that looking at a CLTV/unemployment grid, default rates are far more dependent on *CLTV* than on unemployment. We do, however, find that for an owner-occupied borrower, high unemployment rates in the area can amplify the default rate if the borrower is already significantly underwater. While it is difficult to disentangle the effects of negative equity and unemployment when both are present, one explanation consistent with the evidence is that borrowers with negative equity need a catalyst to default. Unemployment can serve as the catalyst. This effect is particularly apparent for prime borrowers.

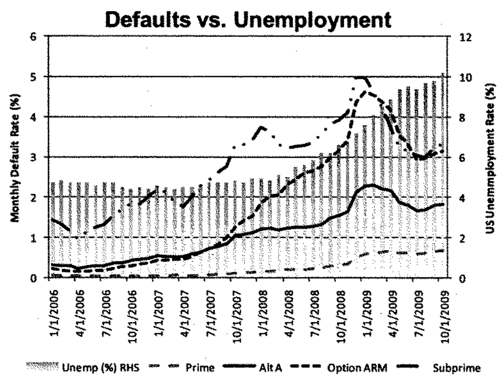
Unemployment Has Lagged Transitions

If unemployment "caused" defaults, we would see unemployment spike before defaults increase. As regular readers of this publication are well aware, we define a "default" as a mortgage that becomes 60+ days delinquent for the first time. That is, we measure the % of loans that transition each month from the "always performing" bucket (loans that have NEVER been more than one payment delinquent) to the "non-performing" bucket (60+ days delinquent). We refer to that as the "sTr" (single month transition rate). In essence, we measure what is coming *into* the default/foreclosure pipeline, not what is *exiting*. We believe this is the correct way to look at defaults; loans that become 60+ delinquent have a very low cure rate, thus they are destined to liquidate (while a mortgage may take another 18 months to actually liquidate, the fate of that loan was largely sealed when it went 60+ days past due!). For a full description of the rationale for this, see our August 11, 2009 *Amherst Mortgage Insight* article entitled "Warning—Non-Agency Yields May be Lower than Expected."

Exhibit 1 (next page) shows that unemployment could not have "caused" transitions—the timing actually runs in the opposite direction. Monthly default transition rates actually ticked *up* well before unemployment rose. Default transition rates for subprime, Alt A and option ARMs began to rise sharply in Q2 2007, whereas unemployment did not substantially increase until Q3 2008. The increases in prime transition rates are more contemporaneous with the increases in unemployment, although small increases in prime transition rates were evident before the increases in unemployment. Essentially, the "mortgage problem" weakened the broader economy, causing the rise in unemployment. Meanwhile, the pull-back in credit availability and the increased supply of homes on the market due to foreclosure also caused home prices to decline further, leaving borrowers with negative equity, and causing transitions rates to further increase.

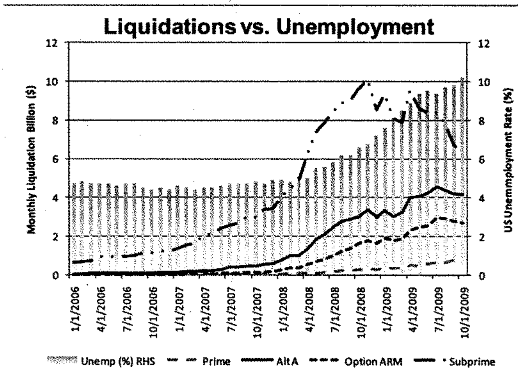
Some researchers have found a stronger correlation between liquidation and unemployment, as shown in Exhibit 2 (next page). It appears that the rise in liquidations coincides with a rise in unemployment. But correlation does not imply causation; rather, this is an accident of timing. It is inconceivable that a borrower becomes unemployed, and his loan is liquidated immediately (as a causation argument would require). Rather, once a borrower stops paying, he moves through the delinquency/foreclosure/REO process, which takes 18 months on average.

Exhibit 1. Default Transition Rates vs. Unemployment



Source: Loan Performance, Bureau of Labor Statistics, Amherst Securities

Exhibit 2. Liquidation Rates vs. Unemployment



Source: Loan Performance, Bureau of Labor Statistics, Amherst Securities

This material has been prepared by individual sales and/or trading personnel and does not constitute investment research.

Thus, what is being liquidated at any particular point reflects paper that stopped paying 18 months earlier. Meanwhile, over that same period, as a result of the deteriorating housing market, the economy weakened and unemployment picked up.

So far we have only shown that defaults lead unemployment. This still does not create a case in and of itself that CLTV matters more than unemployment. So we dig further.

CLTV vs. Unemployment

Exhibit 3 (below) shows average default transition rates over the past 3 months by unemployment/ CLTV bucket. To generate this exhibit, we did the following:

Exhibit 3. Monthly Default Transition Rates (by CLTV, Unemployment Rate)

Prime

Unemployment Rate 3Mo Ago (%)	CLTV <= 80	CLTV 81-100	CLTV 101-120	CLTV > 120
<= 8.0	0.22	0.48	0.68	1.46
8.1-10.0	0.20	0.51	0.82	1.68
10.1-12.0	0.19	0.64	0.93	1.88
> 12.0	0.24	0.51	0.92	2.10

Alt-A

Unemployment Rate 3Mo Ago (%)	CLTV <= 80	CLTV 81-100	CLTV 101-120	CLTV > 120
<= 8.0	0.65	1.34	1.78	2.97
8.1-10.0	0.56	1.29	1.90	3.17
10.1-12.0	0.46	1.17	1.79	3.52
> 12.0	0.60	1.18	1.60	3.49

Option ARM

Unemployment Rate 3Mo Ago (%)	CLTV <= 80	CLTV 81-100	CLTV 101-120	CLTV > 120
<= 8.0	1.19	1.91	2.28	3.82
8.1-10.0	0.88	1.51	2.35	3.87
10.1-12.0	0.58	1.69	2.38	4.25
> 12.0	1.30	2.37	2.29	4.65

Subprime

Unemployment Rate 3Mo Ago (%)	CLTV <= 80	CLTV 81-100	CLTV 101-120	CLTV > 120
<= 8.0	1.52	2.91	3.83	4.90
8.1-10.0	1.35	2.79	4.00	5.30
10.1-12.0	1.15	2.41	3.61	5.59
> 12.0	1.38	2.28	2.79	5.25

Source: Loan Performance, Bureau of Labor Statistics, Amherst Securities

1. We categorized "always performing" loans (never 60+ days delinquent) by unemployment/ CLTV bucket 3 months ago. We sorted the loans into 16 buckets. The unemployment rate is the monthly rate 3 months ago for the MSA in which the loan is located. If we didn't have MSA, we used county level; if lacking that, we matched at the state level. For CLTV, we used the Case Shiller Index to mark-to-market. We first tried to match the loan at the zip code level, then at the MSA level, and finally, at the state level (last resort – if state data unavailable, we used OFHEO state data). We also used loan size tiering data when applicable.

2. We then looked at loans in each category, and calculated the average monthly rate at which they transitioned into the non-performing bucket (60+ days delinquent).

It is important to realize that we cannot tie the employment status of an individual loan to a particular borrower; we can only tie unemployment rate of that MSA to a resident borrower. While we use a similar methodology to derive mark-to-market CLTV from original CLTV, the distortion is likely to be less dramatic for CLTVs. That is, if the unemployment rate in a particular area is only 10%, a particular borrower is only 10% likely to be unemployed. However, if homes in a given area have depreciated by 40%, that borrower's house is likely to have dropped a relatively similar amount. Said another way, HPD is an event that is highly correlated across borrowers while unemployment is not.

Three conclusions emerge from the analysis (we use the Alt-A numbers to illustrate):

- *CLTV plays a critical role.* If we focus on the best of the best loan category (the lowest unemployment bucket (<8%)/lowest MTM CLTV bucket (<80)), the transition rate is 0.65%/month. If we observe underwater borrowers in the same low unemployment MSA, (unemployment <8%, MTM CLTV >120), the default transition rate rises to 2.97%, which is a 4.5 fold increase.

- *If a borrower has positive equity, unemployment plays a negligible role.* If CLTV <80, transition rates are virtually the same regardless of an area's unemployment. That makes sense, because if a borrower cannot make mortgage payments, he sells the house at a profit.

- *If a borrower has substantial negative equity (MTM CLTV >120), employment plays a role, but far less than CLTV.* For a *low* unemployment area, the transition rate is 2.97%/month, but it is 3.5% for a *high* unemployment area.

Note that the effects of unemployment are more pronounced for prime borrowers than for other categories (Alt-A, Option ARM, subprime). Even on prime loans, CLTV is far more important. For prime loans in high unemployment areas, transition rates rise from 0.24% to 2.1%/month (almost a 9-fold increase) as MTM CLTV increases from <80 to >120.

We extend this analysis another step in Exhibit 4 (below) by breaking the Exhibit 3 categories into owner-occupied and non-owner occupied (the latter will include both investor properties and 2[nd] homes).

Exhibit 4. Monthly Default Transition Rates (by Occupancy, CLTV, Unemployment Rate)

Prime

		CLTV (%)			
CLTV	Unemployment Rate 3 Mo Ago (%)	<= 80	81-100	101-120	> 120
Owner Occupied	<= 8.0	0.24	0.50	0.70	0.84
	8.1-10.0	0.23	0.51	0.85	1.77
	10.1-12.0	0.17	0.55	0.90	1.78
	> 12.0	0.24	0.65	0.98	2.32
Non Owner Occupied	<= 8.0	0.14	0.39	0.47	1.25
	8.1-10.0	0.14	0.38	0.55	1.33
	10.1-12.0	0.15	0.58	0.59	1.22
	> 12.0	0.19	0.18	0.52	1.23

Alt-A

		CLTV (%)			
CLTV	Unemployment Rate 3 Mo Ago (%)	<= 80	81-100	101-120	> 120
Owner Occupied	<= 8.0	0.68	1.39	1.86	2.53
	8.1-10.0	0.67	1.41	2.15	3.50
	10.1-12.0	0.47	1.11	1.73	3.35
	> 12.0	0.71	1.21	1.69	3.93
Non Owner Occupied	<= 8.0	0.56	1.36	1.94	1.92
	8.1-10.0	0.54	1.47	1.80	2.75
	10.1-12.0	0.30	0.92	1.35	2.70
	> 12.0	0.54	1.04	1.33	2.72

Option ARM

		CLTV (%)			
CLTV	Unemployment Rate 3 Mo Ago (%)	<= 80	81-100	101-120	> 120
Owner Occupied	<= 8.0	1.10	2.10	2.43	3.46
	8.1-10.0	0.93	1.67	2.44	4.01
	10.1-12.0	0.66	1.40	2.31	4.14
	> 12.0	1.85	2.43	2.48	4.91
Non Owner Occupied	<= 8.0	1.42	1.64	2.20	2.79
	8.1-10.0	0.90	1.46	2.48	3.58
	10.1-12.0	0.60	1.73	1.91	3.60
	> 12.0	0.78	2.14	1.98	3.93

Subprime

		CLTV (%)			
CLTV	Unemployment Rate 3 Mo Ago (%)	<= 80	81-100	101-120	> 120
Owner Occupied	<= 8.0	1.48	2.91	3.97	4.52
	8.1-10.0	1.47	2.92	4.32	5.44
	10.1-12.0	1.08	2.26	3.32	5.53
	> 12.0	1.36	2.40	2.96	5.44
Non Owner Occupied	<= 8.0	1.62	3.02	3.09	2.89
	8.1-10.0	1.61	2.93	3.47	4.00
	10.1-12.0	1.27	2.86	4.16	4.64
	> 12.0	1.64	1.96	1.97	3.97

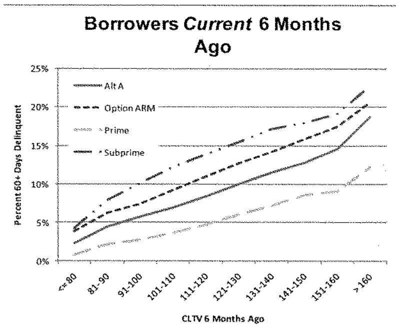
Source: Loan Performance, Bureau of Labor Statistics, Amherst Securities

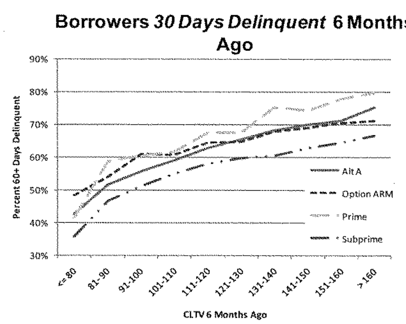
Note that for non-owner occupied properties, CLTV matters much more than does unemployment. In fact, the differences by unemployment rate are very marginal. Sometimes higher unemployment areas actually have lower default transition rates (sTr), which reflects noise as a result of the small size of some buckets.

Even for owner-occupied properties, unemployment only has a large impact where CTLV >120. That also makes sense. A borrower does not usually wake up one day and decide to default. Rather, some event acts as a catalyst. There is a change in financial circumstances that makes paying the mortgage more difficult and forces re-evaluation of financial priorities. Job loss certainly functions as that type of catalyst. When confronted with a catalyst that forces re-evaluation of financial priorities, the borrower will place an underwater mortgage much further down on the list. This pattern is most clear for prime borrowers. For owner-occupied prime borrowers with CLTV >120, the default transition rate is 0.84%/month in low unemployment areas, and 2.32%/month in high unemployment areas. This is very disturbing, as it suggests that the combination of negative equity and a catalyst such as unemployment can cause dramatic rises in default transitions.

Further evidence of the importance of the catalyst comes from Exhibit 5 (below). We took the borrowers that were "always performing" (those who were never more than one payment delinquent) 6 months ago, and divided them into two mutually exclusive groups—one group that was current, another group that was 30 days delinquent. We marked each loan to market, and calculated the MTM CLTV. We then looked at the status of each loan 6 months later to see whether they have become at least 60+ days delinquent. The left hand side of Exhibit 5 shows that "always performing" borrowers who were current have a fairly low probability of going 60 days delinquent 6 months later. For a prime borrower with a CLTV >150, the probability of default is on the order of 10%, whereas it is on the order to 20% for sub-prime borrowers. On the right side of Exhibit 5, we show the results for "always performing" borrowers who were 30 days behind. The borrowers have a much higher probability of defaulting, particularly with negative equity. And prime borrowers are the most merciless defaulters. Once they are 30 days behind for any reason, they are most apt to strategically re-evaluate priorities, then to strategically default when a loan is seriously underwater. A prime borrower with a CLTV <80 has a roughly 40% chance of being at least 60 days delinquent 6 months later. For a 30-day delinquent prime borrower with a CLTV >150, the probability of being at least 60 days delinquent 6 months later is 75%.

Exhibit 5. A Catalyst = *Important*!





Source: Loan Performance, Amherst Securities Group LP

This material has been prepared by individual sales and/or trading personnel and does not constitute investment research.

Conclusion

CLTV is a far more important predictor of default than is unemployment, but the interactions between the two cannot be neglected. We demonstrated that:

- Mortgages were transitioning into the non-performing bucket long before unemployment picked up.
- CLTV always plays a critical role in determining default transition rates
- Unemployment does not matter at all for mortgages with low CLTVs.
- At CLTVs >120, unemployment amplifies the likelihood a borrower will default (it forces a strategic re-evaluation of financial priorities).

BOTTOM LINE—*The evidence is irrefutable. CLTV is the most important predictor of default. This issue must be addressed by giving principal reduction higher priority when doing the modification. It is important to realize that when the borrower has negative equity, unemployment acts as a catalyst, significantly increasing the likelihood that the loan will default.*

Contact Us

Austin
Corporate Office
7801 N. Capital of Texas Hwy
Suite 300
Austin, TX 78731

(512) 342-3000
(800) 396-3311 toll free
(512) 342-3097 fax

Boca Raton
925 South Federal Highway
Suite 210
Boca Raton, FL 33432

(561) 620-5855
(888) 235-0009 toll free
(561) 620-8995 fax

Chicago
500 West Madison
Suite 3140
Chicago, IL 60661

(312) 224-9977
(877) 499-9977 toll free
(312) 224-9980 fax

Greenwich
Two Greenwich Office Park
First Floor
Greenwich, CT 06831

(203) 618-1133
(800) 556-1133 toll free
(203) 618-1475 fax

Greenwood Village
8400 East Prentice Avenue
Suite 1500
Greenwood Village, CO 80111

(303) 409-7665
(303) 409-7666 fax

Houston
1300 Post Oak Boulevard
Suite 850
Houston, TX 77056

(713) 888-9100
(800) 856-1111 toll free
(713) 888-9180 fax

McLean
1650 Tysons Boulevard
Suite 650
McLean, VA 22102

(703) 848-8300
(800) 848-5420 toll free
(703) 848-8838 fax

New York City
444 Madison Ave.
7th Floor
New York, NY 10022

(212) 593-6030
(212) 593-6099 fax

Red Bank
65 Monmouth St.
Suite 307
Red Bank, NJ 07701

(732) 212-1661
(866) 933-9901 toll free
(732) 212-1766 fax

Westport
55 Saugatuck Avenue
Westport, CT 06880

(203) 221-8112
(877) 221-8115 toll free
(203) 221-8114 fax

Disclaimer

The material contained herein is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of securities. Any investment decision as to any purchase or sale of securities referred to herein must be made solely on the basis of existing public information on such security and/or any registered prospectus, and that no reliance may be placed on the completeness or accuracy of the information and/or comments contained in this document. The decision of whether to adopt any strategy or to engage in any transaction and the decision of whether any strategy or transaction fits into an appropriate portfolio structure remains the responsibility of the customer and/or its advisors. Past performance on the underlying securities is no guarantee of future results. This material is intended for use by institutional clients only and not for use by the general public. Amherst® Securities Group LP has prepared portions of this material incorporating information provided by third party market data sources. Although this information has been obtained from and based upon sources believed to be reliable, Amherst® Securities Group LP does not guarantee the accuracy or completeness of the information contained herein. Amherst® Securities Group LP cannot be held responsible for inaccuracies in such third party data or the data supplied to the third party by issuers or guarantors. This report constitutes Amherst® Securities Group LP's opinion as of the date of the report and is subject to change without notice. This information does not purport to be a complete analysis of any security, company or industry. Amherst® Securities Group LP cannot and does not make any claim as to the prepayment consistency and/or the future performance of any securities or structures. Change in prepayment rates and/or payments may significantly affect yield, price, total return and average life. Amherst® Securities Group LP may have a position in securities discussed in this material.

This material has been prepared by individual sales and/or trading personnel and does not constitute investment research.

THE WALL STREET JOURNAL.

- WSJ.com

- OPINION
- NOVEMBER 24, 2009, 8:58 A.M. ET

Homebuyer Tax Credits Threaten the FHA
Funding a down payment with the credit increases the odds the buyer will default.
By ROBERT C. POZEN

A few weeks ago, President Barack Obama signed legislation extending an $8,000 tax credit for first-time home buyers. The refundable tax credit, available even if a family has no taxable income, will enable many more buyers to close on a home. But it also could bankrupt the Federal Housing Administration (FHA) and, by doing so, damage an already weak housing market.

The tax credit was put in place as part of the stimulus package signed into law earlier this year. Initially, it was available only to first-time buyers with a combined income of $150,000 or less ($75,000 for individuals). Approximately 40% of all first-time buyers used the credit in 2009, so extending it was strongly supported by real estate brokers, home builders and their congressional allies.

The extension the president signed makes the credit available to first-time buyers, but also to people who have owned a home for at least five years. In addition, it raises the maximum income for a qualified buyer to $225,000 a year for couples and makes the credit available until mid-2010. (It had been set to expire at the end of this month.)

The problem is that the FHA insures mortgages of homes below certain price levels with such a low down payment that it can be funded solely by the refundable tax credit. And, as we've seen in the recent housing crisis, buyers with no skin in the game are more likely than others to default on their mortgages when the value of their home falls below their mortgage balance.

Here's how the credit allows buyers to avoid putting their own money at risk. Suppose a couple making $60,000 annually buys a home worth $200,000. They can get an FHA-insured loan if they put down 3.5% of the purchase price, about $7,000. The couple will also need to come up with another $1,000 in closing costs, for a total of $8,000. The couple can either dip into savings or borrow that money from relatives or somewhere else on a temporary basis.

After closing, the couple can quickly obtain the $8,000 refundable tax credit to pay off their temporary loan (or replenish their savings). In effect, they will have bought a home without putting any of their own money at risk. Owners who don't sink their own money into a house are much more likely to default on the mortgage.

The FHA already is facing a rising number of serious problems on its insured mortgages. Last week the agency reported that its cash reserves dropped to 0.53% of the $685 billion of total loans it insurers. This is well below the 2% federal law requires the FHA to have in reserves.

Beyond these reserves, the FHA has roughly $28 billion in a capital surplus fund, established by Congress to absorb losses on insured mortgages over the next 30 years. With the reserves and capital in hand, agency officials believe they have enough cushion to avoid needing a federal bailout. But a recent government audit concluded that the FHA would run out of money in 2011 and need a federal bailout if we have a protracted recession.

The deteriorating quality of the FHA's mortgage portfolio is a critical challenge to the housing market and the federal budget. By the end of next year, the FHA's portfolio is projected to rise to $1 trillion. Currently, over 20% of all new home mortgages are insured by the FHA.

Meanwhile, the tax credit for first-time home buyers is expected to cost the Treasury approximately $15 billion in 2009—more than twice the projected cost when Congress approved the stimulus package. Some of the cost overrun is due to fraud. At least 19,000 filers who claimed $139 million in tax refunds under this credit did not actually buy a home, according to Treasury officials. In addition, 74,000 filers claiming a total of $500 million in refunds seem to already have owned a home.

We all want to help first-time buyers acquire homes and support the depressed U.S. housing market. Without real down payments, however, new homeowners are likely to default on their mortgages, and the FHA will probably need a taxpayer bailout.

The Obama administration should increase the requirements to qualify for an FHA-insured mortgage. In addition to the 3.5% down payment, the administration should also require that buyers put down at least half of the tax credit they will receive for buying the home.

Mr. Pozen, chairman of MFS Investment Management and senior lecturer at Harvard Business School, is the author of "Too Big to Save? How to Fix the U.S. Financial System" (Wiley, 2009).

O