

**MEMORANDUM**

To: Members of the Committee on Financial Services

From: FSC Majority Committee Staff

Date: April 5, 2013

Subject: April 10, 2013, Housing and Insurance Subcommittee Hearing entitled “Sustainable Housing Finance: Perspectives on Reforming FHA”

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On Wednesday, April 10, 2013, at 10:00 a.m. in room 2128 of the Rayburn House Office Building, the Housing and Insurance Subcommittee will hold a hearing on “Sustainable Housing Finance: Perspectives on Reforming FHA.” The hearing will explore potential reforms for the Federal Housing Administration (FHA).

This will be a one-panel hearing consisting of the following witnesses: Mr. Adolfo Marzol, Vice Chairman, Essent US Holdings; Mr. David Stevens, President, Mortgage Bankers Association; Mr. Gary Thomas, 2013 President, National Association of Realtors; Mr. Kevin Kelly, First Vice Chairman, National Association of Home Builders; Ms. Sarah Rosen Wartell, President, Urban Institute; and Dr. Clifford Rossi, University of Maryland.

**The Role of the Federal Housing Administration**

The National Housing Act of 1934 established the FHA, which is housed within the Department of Housing and Urban Development (HUD), and gave it the mission of providing federal mortgage insurance in order to provide stability and liquidity in the market, broaden homeownership, protect lending institutions, and stimulate the building industry. The FHA’s mortgage insurance program created the 20-year, fixed-rate mortgage, which ultimately expanded to a 30-year term and led to standardized mortgages. The FHA does not originate loans, but rather insures mortgages issued by banks and other lenders. The FHA is intended to be self-funded; premiums paid by homeowners for FHA mortgage insurance are used to cover losses when loans default.

During the housing boom of the mid-2000s, the FHA’s share of the mortgage market fell precipitously, and stood at under two percent of mortgage originations (measured by dollar volume) by the end of 2006. As housing prices began to decline, lenders tightened their underwriting criteria and the FHA began playing a larger role in the mortgage market. The Congressional Research Service (CRS) reported that during FY 2010, the FHA guaranteed nearly 40 percent of mortgages originated or refinanced, which corresponds to approximately 1.1 million homebuyers. FY 2010 was the second time that the FHA insured more than 1 million

homebuyers in a single year. In terms of measuring the mortgage insurance market, as of the third quarter of 2012, the FHA's market share could be viewed as either 56.4 percent of all insured mortgages, based on the total number of loans, or, alternatively, 45 percent of all insured loans, based on dollar volume. According to the FHA, the federal mortgage insurance program currently insures more than \$1 trillion worth of mortgages on more than 7 million loans.

In recent years, more homebuyers have turned to FHA-insured loans to take advantage of its lower down-payment requirements, which are currently set at 3.5 percent of the property's appraised value. Larger down payments make it more difficult for first-time and low- or moderate-income homebuyers to purchase houses; thus, when banks and private mortgage insurance companies tightened their underwriting criteria and required down payments greater than 3.5 percent, many borrowers turned to FHA-insured mortgages as an alternative.<sup>1</sup>

At the same time that the FHA's market share has grown, the FHA—like most other participants in the mortgage market—faces higher default rates. The FHA thus finds itself supporting the mortgage market by insuring new home loans at the same time that it seeks to shore up the solvency of its single-family insurance fund, known as the Mutual Mortgage Insurance Fund (MMIF). The MMIF's capital reserve ratio—which is a measure of the MMIF's strength—fell below the statutorily required two percent for the first time in FY 2010 to 0.50 percent. The two percent capital reserve ratio was established by the Omnibus Budget Reconciliation Act of 1990, at a time when many were concerned about the solvency of the FHA. The capital reserve ratio is defined as the MMIF's economic value divided by the total insurance-in-force. The FHA's ability to meet the two percent capital reserve requirement has historically been viewed as evidence of the strength and stability of its MMIF.

### **FHA's FY 2012 Actuarial Report and Health of Single-Family Insurance Fund**

On November 16, 2012, HUD released the FHA's FY 2012 Actuarial Report, which showed further deterioration in the MMIF's capital reserve ratio. During FY 2012, the MMIF's capital reserve ratio fell to *negative* 1.44 percent, which means that the FHA does not have sufficient reserves to cover its expected losses. The FY 2012 Actuarial Report also noted that the MMIF's economic value was *negative* \$16.3 billion, which is the projected amount the FHA would lose if it stopped insuring new mortgages and covered its projected losses. The MMIF's *negative* \$16.3 billion economic value represents a decrease of \$17.49 billion from its \$1.19 billion economic value at the end of FY 2011, which resulted from further declines in national home prices, more loans having elevated default potential, and uncertain economic conditions.

The FHA is thus vulnerable to further defaults. To cover these defaults, the FHA may be required to resort to its "permanent indefinite authority" to draw funds directly from the U.S. Treasury to pay unexpected increases in insurance claims. Because the FHA guarantees 100 percent of the loan amount on the mortgages it insures and is ultimately backed by the federal

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<sup>1</sup> Darryl E. Getter, "Federal Housing Administration (FHA) and Risky Lending," CRS Report for Congress R40937, June 10, 2010, available at <http://www.crs.gov/Products/r/pdf/R40937.pdf>.

government, a large number of defaults could result in significant losses to the FHA; those losses may ultimately be borne by taxpayers. Nonetheless, the FY 2012 actuarial report does not necessarily mean that the FHA will draw funds from the Treasury. Congress and the public will have a better sense of whether the FHA will tap the Treasury when the Obama Administration releases its FY 2014 budget proposal on April 10<sup>th</sup>. If the FHA expects to draw funds from the Treasury, the President's budget will contain an estimate of the amount that it expects to borrow to cover potential shortfalls.

### **Concerns about the Solvency of the MMIF**

The Financial Services Committee has held three hearings in the 113<sup>th</sup> Congress on the FHA and its fiscal health. Most recently, on March 13, 2013, the Housing and Insurance Subcommittee received testimony from a panel of analysts and experts who discussed whether the FHA's government-conferred advantages and current practices are preventing private capital from entering the market.

On February 14, 2013, the U.S. Government Accountability Office (GAO) designated FHA as a high risk agency in its 2013 High Risk Series Report, which is updated every two years at the beginning of each Congress. In its section entitled, "Modernizing the U.S. Financial Regulatory System and Federal Role in Housing Finance," GAO states that "a weakening in the performance of FHA-insured mortgages has heightened the possibility that FHA will require funding from the U.S. Treasury to help cover its costs on insurance issued to date."

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