EXAMINING THE PROPER ROLE OF THE FEDERAL HOUSING ADMINISTRATION IN OUR MORTGAGE INSURANCE MARKET

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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HOUSE COMMITTEE ON FINANCIAL SERVICES

JEB HENSARLING, Texas, *Chairman*

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EXAMINING THE PROPER ROLE OF THE FEDERAL HOUSING ADMINISTRATION IN OUR MORTGAGE INSURANCE MARKET

Wednesday, February 6, 2013

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

The committee met, pursuant to notice, at 9:02 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Miller, Bachus, Royce, Capito, Garrett, Neugebauer, McHenry, Campbell, Pearce, Posey, Westmoreland, Luetkemeyer, Huizenga, Duffy, Renacci, Hurt, Stivers, Fincher, Stutzman, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Cotton; Waters, Maloney, Velazquez, Watt, Sherman, Meeks, Capuano, Clay, Green, Cleaver, Himes, Carney, Sewell, Foster, Kildee, Murphy, Delaney, Sinema, Beatty, and Heck.

Chairman HENSARLING. The committee will come to order.

Without objection, the Chair is authorized to declare a recess of the committee at any time.

Opening statements will be limited to 10 minutes per side. At this time, I will yield myself 3 minutes for an opening statement.

Last week, many of us awoke to the news that we had negative economic growth in the last quarter. Although one quarter does not make a trend, it was not welcome news, and it was not expected news. Unfortunately, what has become expected news is subpar 1½ to 2 percent economic growth, when historic trends are above 3 percent, and clearly, the economy is capable of 4 percent or greater. Two percent economic growth means that millions of Americans lay awake at night pondering insecure financial futures for themselves and their families.

Hardworking Americans demand a healthy economy, and we cannot have a healthy economy until we have a housing finance system that is both sustainable and competitive. In its current form, the Federal Housing Administration (FHA) is clearly an impediment to such a system. Because of this, the Financial Services Committee today is holding its first in a series of hearings to examine the FHA, now the largest mortgage insurance company in the United States.

Historically, FHA has represented roughly 10 percent of the mortgage insurance market and has fulfilled its role of being the provider of mortgage credit for certain discrete populations, particularly first-time home buyers and low- and moderate-income Americans who qualify under stringent tests.

Today, however, FHA has strayed far from its original mission and legislative purpose. It doesn't just focus on low- and moderate-income Americans; it provides mortgage insurance for expensive homes valued as high as $729,000. By offering riskier terms than private competitors, the FHA today controls 56 percent, more than half of the total mortgage insurance market in terms of numbers of loans. Talk about too-big-to-fail. So instead of complementing a robust private mortgage market, the FHA's high-cost loan limits and extremely low downpayment requirements put it in direct competition with the private sector.

In addition, we know that as bad as that is, its single-family insurance fund is flat broke. The independent actuarial study released last November shows that the FHA single-family mutual insurance fund has a negative—I repeat negative—economic value of $16.3 billion. If the FHA were a private financial institution, it is likely that somebody would be fired, somebody would be fined, or the institution would find itself in receivership. Instead, it is merrily on its way to becoming the recipient of the next great taxpayer bailout.

Finally, given their high-loan-to-value, low-credit-score policies and high rates of default, it is an open question whether FHA has now morphed into Countrywide. Arguably, the FHA has now become the Nation's largest subprime lender, all with the blessings of the Administration.

FHA's loan downpayment lures families into having an unrealistic view of homeownership obligations. Their high loan limits encourage people to buy more home than they can possibly afford to keep. Putting borrowers in homes where one in eight loans end in default, the FHA can make entire communities worse off, trapping more and more families as property values fall. You do not help families achieve the American dream by putting them into homes they cannot afford. This is how you turn the American dream into a nightmare.

I will now yield 3 minutes to the gentleman from Texas, Mr. Neugebauer, the chairman of the Subcommittee on Housing and Insurance.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, for holding this important hearing.

And I want to thank our witnesses for your testimony and for your being here today. I think this is an important hearing.

What we do know is that there is kind of a trend here, that government doesn't do a good job at pricing risk. We see that manifest itself currently at FHA, and that did not evidently set the right risk premium because, as the chairman alluded to, there is $16 billion underwater, and the trend is not good. I think we have seen another example of that, for example, in the Flood Insurance Program, which is $20 billion in the hole.

What we are learning, I think, is that the government has a hard time being in the insurance business. And in many cases, by the government being in the insurance business, we are crowding out the private sector. That is not a good trend. I think it detracts from the core mission of what government should be doing.

We have had a number of projections that this fund was going to be get healthier each year over the last 3 years' testimony. But, in fact, the fund hasn't gotten healthier; it has gotten unhealthier—$16 billion underwater, almost a negative 1.44 percent.

I think the other troubling thing, though, is the mission creep that has happened at FHA over the years. Basically when—I am a homebuilder and I have been in the real estate business for over 30 years. I know I don't look that old. But, I think the thing when FHA was originally started, it was to help kick-start a certain group of people, help them get into homeownership. But now we see we have an agency that controls over 50 percent of the mortgage insurance in this country and almost 30 percent of the origination market, with loan limits now of over $700,000. This is not your mother's or your father's FHA. And, in fact, about 90 percent of the portfolio, I believe, that is in FHA now would not qualify under the original standards that were set up.

And so I think it is important that we have a hearing and begin to set FHA on the track of its original mission, but also, more importantly, to create some space for the private sector to come back into the market.

So when we have all of these discussions, what is the bottom line here, what is the important thing here? The important thing here is that homeownership is an important part of the American dream, but we don't, as the chairman said, want to turn it into the American nightmare by having policy at the Federal level that infringes not only on the rights of the people trying to get into the housing market, but also damaging the people who are already homeowners in this country. And I think we have seen over the last few years where that has actually been the case, and basically then infringes on everyone's rights by the fact that we are not making the right policies.

So I look forward to the testimony of the witnesses. And, with that, I yield back. Thank you, Mr. Chairman.

Chairman HENSARLING. The gentleman from Massachusetts is recognized for 3 minutes.

Mr. CAPUANO. Thank you, Mr. Chairman.

Mr. Chairman, I am glad that we are having this hearing. I am glad we are going to be looking at the FHA and hopefully the entire problem of being able to buy and maintain housing in this country. But I think that we need to be a little careful with some of the rhetoric. I don't think there are many independent people who think we are looking at the next great bailout.

Yes, the FHA is a little bit of an issue at the moment because of its countercyclical mission. By the way, it was part of their original mission to come in during difficult times. They did that, and they are in trouble because of it. We all understand that. Everybody here wants to make sure to the best of our ability as quickly as possible the housing industry can get back to normal. No one likes or enjoys this crisis or any aspect of it, not just in housing, but housing is the issue today.

So as we go forward, for me, I am certainly looking for ways to improve the FHA and other lending agencies. I am certainly looking for ways to protect the American taxpayer. We are all looking for that. But I also want to make sure in doing that, we don't throw the baby out with the bath water. Because let's not forget that for 80 years, the FHA helped with a critical aspect of building the middle class, of building equity.

I say this as a person who comes from a district that really doesn't benefit much from the FHA. And I say that because my district is a high-cost district. The FHA cannot make many loans in my district. In 2011, they made 5,000 loans in my district. In the Fifth District in Texas, they made 25,000 loans. And that is just typical. I understand that, but I don't live on an island. My district will do fine with or without the FHA, to be perfectly honest. But I don't live on an island, and I want all Americans to enjoy the middle class. I want all Americans to have an opportunity to move into that middle class by building equity, the same way I did. I bought my house 30 years ago. It was not allowed to qualify for the FHA. And I had a higher debt-to-income ratio than most people because that house was expensive and my income didn't match it. But we did it, as many Americans do.

So, yes, we have problems, and, yes, we need to address them, and, yes, we need to ask a lot of serious, difficult questions and debate what the right answer is. We also have to understand the FHA has taken a lot of actions, some of which I am not even sure I support. But it is not like everybody has been sitting on their hands or anybody wants to drive this country into bankruptcy.

The housing crisis happened. The default rates for private mortgages are actually higher than those for the FHA—a lot higher in some instances, particularly in subprime.

So I welcome the discussion. I look forward to the debate. More importantly, I look forward to a hopefully thoughtful discussion on what things we should do to make sure that the FHA or some other agency similar to it is around for the next generation and the next generation after that so that the middle class or people trying to get into the middle class will still have the hope that we have had.

Thank you, Mr. Chairman. I yield back.

Chairman HENSARLING. The gentleman from California, Mr. Miller, is recognized for 1 minute.

Mr. MILLER. Thank you, Mr. Chairman.

So that the FHA can play a countercyclical role in the future, as we have discussed, we must ensure the FHA program better manages the risk it is taking on. To preserve the countercyclical role, FHA must lessen taxpayer exposure. This can be accomplished in 3 ways.

One, we must take a close look at the business model and management of the FHA. We need to look inside the FHA to ensure its policies, management, and technology can handle times of increased pressure.

Two, we need to ensure appropriate credit quality for those receiving FHA loans. While the current book of business shows the FHA has made progress, we need to consider whether these actions have been enough. Are current FHA underwriting requirements basically adequate to keep default rates low in the future?

We should also look at the structure of the FHA mortgage insurance product itself. Is there a way for FHA to preserve its function in a way that requires less taxpayer exposure?

And, finally, we must demand the FHA remain adequately capitalized. We need to be careful not to disrupt the fragile housing recovery by abruptly pulling back liquidity. Liquidity right now is, above all, important to keep the housing market going and recovering. And so we need to be very cautious about what we do, but we do need to require accountability.

I yield back.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York for 2 minutes.

Mrs. MALONEY. I want to thank you for calling this hearing, and I welcome all the witnesses.

Our housing market and recovery is critically important to this committee and will probably be one of the main issues that we look at over the next 1 or 2 years. Economists have estimated that housing's impact on our economy is 25 percent of our economy. So whether or not it is healthy and growing and balanced is critical to our economic recovery. And it is important that we, here in this hearing, study exactly what went wrong in the housing crisis and see what we can do to promote prudent lending and a vibrant secondary market.

The FHA role in housing is countercyclical. At one point, it was as low as 5 percent. But in times of crisis, its portfolio expands, and then it contracts in good times. We were fortunate to have them there during the financial crisis, as they did come in and help finance housing. FHA insured nearly 1.2 million single-family mortgage loans in 2012 alone, with a total value of $213 billion. And it has continued to play a role for first-time home buyers and for home buyers in minority communities and lower income brackets.

So it is, of course, a logical question to ask in the wake of one of the worst financial crises in our lifetime how the Mutual Mortgage Insurance Fund is functioning and whether the stress that was placed on the fund will require a credit or a support.

I wrote to HUD in November of last year and asked this exact question. I ask permission to put my letter in the record.

Chairman HENSARLING. Without objection, it is so ordered.

Mrs. MALONEY. I have not yet received a response, so I hope I will hear some answers today from the witnesses.

Thank you. My time has expired.

Chairman HENSARLING. The Chair now recognizes the gentleman from New Jersey for 1½ minutes.

Mr. GARRETT. And I thank you, Mr. Chairman.

So here we are again, another year, another multi-billion-dollar taxpayer bailout for the housing market. And so I guess the question is, when are we going to learn?

The continued oversubsidization of the housing market doesn't help the consumer, it doesn't help the borrowers, it doesn't help the neighborhoods, and it doesn't help the economy. You see, this housing bust that triggered the financial crisis was mainly caused by a combination of the Federal Government subsidies into the housing market and also by loose money by the Federal Reserve. And so you had a dangerous mix here that basically destroyed the economy and left millions upon millions of homeowners underwater.

So instead of learning from these past mistakes, this Administration has done what? They have doubled down on their failed policy of throwing billions of taxpayer dollars at the problem and giving almost any individual who wants to buy a home one that is government-financed, with nothing down primarily, and all in the name of what? Just like we have heard over here: the name of countercyclicality.

So instead of ensuring the housing market is put on a more sustainable basis in moving forward, what has the FHA done? They have helped literally thousands of borrowers get into homes that they can't afford, and they wind up now finding that they are underwater and undervalued.

While continuing to spend literally billions of taxpayer dollars to reinflate the housing bubble—and this might temporarily help some of the market participants, those who financially benefit from this in the production and the sales of homes—again, it does nothing to help the consumers, the neighborhoods, the taxpayers, or the economy.

So I look forward to this panel, to drilling down to see how we got here, and how it continues now going forward, and how we get out of this problem in the future.

With that, I yield back.

Chairman HENSARLING. The Chair now recognizes the ranking member, the gentlelady from California, for 5 minutes.

Ms. WATERS. Thank you, Mr. Chairman, for holding this hearing today on the role of the Federal Housing Administration and our mortgage insurance market.

FHA has long been a focus for me. In the last two Congresses, I worked first with Congresswoman Capito when I was chairwoman of the Housing and Community Opportunity Subcommittee, and then with Congresswoman Biggert to pass FHA solvency legislation through the House of Representatives. I was disappointed that the Senate did not take up our legislation, but I remain hopeful that this can be an area for constructive collaboration over this next congressional term.

I think all of the Members here today are deeply concerned about the health of the FHA's Mutual Mortgage Insurance Fund, particularly the finding in FHA's actuarial analysis that the capital reserve ratio of the fund fell below zero in Fiscal Year 2012. So I welcome the opportunity to explore these issues fully in the series of hearings you recently announced.

But along with that concern, I think it is important to acknowledge FHA's crucial role in our housing finance system. Particularly in the last few years, in the aftermath of a housing crisis precipitated by privately funded, poorly underwritten subprime mortgages, FHA stepped up, providing crucial liquidity and access to the mortgage market.

All told, over the course of its 78-year history, FHA has helped more than 34 million Americans achieve the dream of homeownership, with a particular focus on first-time home buyers. In fact, Mark Zandi of Moody's Analytics estimates that if it were not for FHA, home prices could have fallen an additional 25 percent during the most recent economic crisis. So while we all agree that the government footprint in our mortgage market must shrink, we have to balance that concern with an understanding that the presence of FHA has mitigated the length and severity of the housing downturn.

I would also like to explore more fully the recent actions taken by the FHA to address prior problems by tightening up the origination policies and stepping up their lender enforcement efforts. In addition to the ending of seller-funded downpayment assistance, the FHA has initiated five increases to their mortgage insurance premiums, tightened FICO score lending requirements, and reduced allowable seller concessions.

Just last week, FHA announced four additional changes in policy, including raising debt-to-income requirements for borrowers with low credit scores, raising annual mortgage insurance premiums for new borrowers, initiating a moratorium on full cash-out reverse mortgages, and instituting greater oversight of borrowers who are trying to obtain FHA loans after foreclosure.

And it appears that the changes instituted by FHA since 2009 have helped lead to positive books of business for 3 consecutive years, including the 2 strongest books in FHA's history, in 2011 and 2012.

Again, I think that Members and other stakeholders will readily see and understand the significant risk management and policy changes that FHA has and continues to undertake in response to the most recent actuarial review. I look forward to us continuing that educational process through our hearing today as well as future hearings.

And I yield back the balance of my time.

Chairman HENSARLING. The gentlelady from West Virginia is recognized for 1½ minutes for the last word.

Mrs. CAPITO. Thank you, Mr. Chairman. I would like to thank you for convening this morning's hearing.

In light of the latest independent actuarial review of FHA's Mutual Mortgage Insurance Fund, I believe it is a very legitimate concern that FHA will not have sufficient funds to pay the projected claims.

As we have heard, the countercyclical role that the FHA traditionally plays in the mortgage market is an important one. And as our ranking member, Ms. Waters, just mentioned, we have worked diligently to try to put reforms in legislation in prior Congresses to ensure that the agency remains a source of funding for creditworthy borrowers. It is unfortunate that these efforts have not been able to make it beyond the House at a time when they are most needed.

While FHA helped fill a gap in liquidity from 2007 to 2009 as credit markets contracted and lending standards tightened, the resulting increase in market share continues to impede private insurance mortgage market resurgence. Downpayments, conforming loan limits, and premium structures that treat risk differently are all examples of FHA's being able to maintain an advantage in the market and make it much more difficult to restore a healthy and vibrant private market.

I believe a mortgage insurance market dominated by FHA hinders the ability of our economy to function most effectively. The immediate long-term challenges that face the FHA will affect its ability to serve in its traditional manner. Moving in a direction which encourages private capital is the direction I would like to see us go.

And I thank the chairman for this hearing. Thank you.

Chairman HENSARLING. At this time, I want to welcome all of our panelists. Thank you very much for agreeing to testify today.

I do want to tell our panelists and all Members that, regrettably, votes are expected on the Floor sooner than originally anticipated, so the Chair will wield a very tight 5-minute gavel. And although we normally provide very lengthy introductions, instead you will get abbreviated introductions at the moment.

Ed Pinto is a resident fellow at the American Enterprise Institute, having previously served as an executive vice president and chief credit officer at Fannie Mae.

Basil Petrou is the managing partner of Federal Financial Analytics. He has been a consultant on mortgage and housing-related regulatory issues for 20 years. He previously worked at the Treasury Department.

Julia Gordon is the director of housing finance and policy at the Center for American Progress. She previously managed the single-family policy team at FHFA.

Finally, Dr. Anthony Sanders is the finance area chair and a distinguished professor of real estate and finance at the George Mason University School of Management, and is also a senior scholar at George Mason's Mercatus Center.

Again, each one of you will be recognized for 5 minutes to give an oral summary of your testimony. Without objection, each of your written statements will be made a part of the record.

Mr. Pinto, you are now recognized for 5 minutes. And please bring the microphone as close to you as possible.

STATEMENT OF EDWARD J. PINTO, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE

Mr. PINTO. Thank you, Chairman Hensarling and Ranking Member Waters, for the opportunity to testify today.

FHA poses a triple threat. It has an extraordinary failure rate that, as I will show, has continued for decades. It has insolvency on a regulatory and GAAP accounting basis that poses a threat to taxpayers. And it has unfair competition with private capital that is blocking housing finance reform.

This is not the first time this has occurred. This is an excerpt from testimony by the late Gale Cincotta back in 1998 before a subcommittee of this committee, and it reads as if it were written today. It talks about the same issues that we are talking about today. Likewise, on October 8, 2009—and I see many of the Members here who were present in 2009—when I indicated in testimony that FHA was facing a $54 billion capital shortfall, that has come to pass.

FHA is a continuing threat to working-class neighborhoods and families because of the extraordinary failure rate that it experiences year after year. It has an 11 percent average claim rate over the last 37 years. That is the weighted average over 37 years. Its abusive lending practice have led to over 3 million failed American dreams since 1975. People tend to forget how many millions of families have had their dreams dashed by FHA's abusive lending practices. And this foreclosure pain is concentrated year after year after year on working-class families and communities.

This is a chart that shows year-by-year FHA data. It shows the number of claims per year, it shows the average claim rate, and that the cumulative amount of claims is over 3 million.

This shows up very clearly in—just a second. This shows up very clearly in—getting out of order here. I am sorry, getting a little out of order.

This shows up clearly in the masking of this pain. When you deal with lower FICO scores, you are looking at 20 and 30 percent default rates. When you are looking at higher FICO scores and other lower-risk characteristics, you get averages that are below 5 percent. The problem is that averages don't cut it. The averages end up masking the pain. Where that pain shows up is very specifically in neighborhoods that end up being the same neighborhoods year after year.

Chicago is an example of that. This chart shows a study that I completed last year on 2.4 million FHA loans. The Chicago loans are shown here from 2009 and 2010. The highest foreclosure rates are in the orange; the lowest foreclosure rates are in the dark blue. Loan counts show the size. And you see the concentration in the south side of Chicago, part of the west side of Chicago, but there are concentrations throughout Chicago. But these are the same areas that have been talked about for decades.

This chart shows what happens in terms of income in the zip codes and house prices in the zip codes. The lower quadrant on the lower left we call the "quadrant of doom" because that is where the foreclosures are concentrated. They are people with below-average incomes and below-average house prices.

The "enablers of doom" are the usual individuals, but they include investors in Ginnie Mae, they include Ginnie Mae itself, they include regulators, they include real estate agents and homebuilders and many others that are indifferent to the levels of foreclosure, these 3 million foreclosures that FHA has had over the decades.

The insolvency of FHA puts taxpayers at risk because even under very generous accounting rules, FHA now has a negative economic value of $14 billion. But that really understates what is going on because under today's low-interest-rate environment, that negative economic value is in the mid-$30 billion range. And when you add their required capital requirement, you are at the $54 billion number I predicted 3½ years ago.

By unfairly competing with the private sector, it really delays housing finance reform. The FHFA Director said in December that FHA is really the path to deciding on housing finance reform; you have to start with FHA.

Turning hope into homes can be done by following four steps, and I list them there. You should start with some of the provisions from the House-passed bill. You should apply best practices that the VA has shown over the years. Needy families need FHA's full attention. FHA should be targeted on where it can help the most. And, lastly, they should establish a tolerance for failure; just stop making really bad loans. And, finally, I offer to work to with any Member here on accomplishing this tolerance for failure.

Thank you.

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

Chairman HENSARLING. Thank you, Mr. Pinto.

The Chair will now recognize Mr. Petrou for 5 minutes.

STATEMENT OF BASIL N. PETROU, MANAGING PARTNER, FEDERAL FINANCIAL ANALYTICS, INC.

Mr. PETROU. Thank you, Chairman Hensarling and Ranking Member Waters. It is an honor to appear before this committee today to discuss the proper role of the FHA single-family mortgage insurance program in the U.S. mortgage finance system.

FHA plays a vital role. It has an urgent and continuing mission to ensure that the Federal Government supports sustainable homeownership for moderate-income borrowers without access to private capital.

However, I believe that taxpayers should take as little risk as possible, standing back now that the crisis is ebbing to permit private capital to reenter the market under a new robust regulatory framework. With specific regard to FHA, I recommend that Congress should reduce the 100 percent full faith and credit guarantee provided by the FHA to parallel the limited coverage of 25 to 50 percent successfully used by the Veterans Administration.

There are three simple points that demonstrate that 100 percent FHA insurance coverage is self-defeating for FHA and the U.S. taxpayer. First, FHA is exposed to severe losses on every loan that goes to claim during a house price decline, such as that experienced since 2006. Second, FHA exposes itself to fraud and poor underwriting. That is far less likely to occur if the loan originator had skin in the game on every FHA-insured loan it originates. And third, reducing the level of insurance coverage on future FHA loans while holding the FHA premium at its current level would recapitalize the FHA MMI Fund with positive budget scoring.

It is simply impossible for there to be real incentive alignment between mortgage originators and the taxpayer if originators take all the profit and the U.S. taxpayer takes all the risk. Further, the FHA should be targeted to borrowers based on income, not home price. When the U.S. Government supports mortgage finance for higher-income borrowers, it unnecessarily supplants private capital otherwise ready to take on this risk.

Also, since FHA mortgage underwriting is delegated to the lender, the FHA exposes itself to the risk that poor underwriting will only be found after a loss occurs. It is important that the taxpayer be protected at the front end of the loan origination from poor FHA-delegated underwriting. FHA should thus be authorized to engage in risk shares with private providers of credit risk mitigation.

Importantly, the model used by FHA for accessing the actuarial value of its single-family fund is not working. Since 2007, the current model has consistently overestimated its economic value. A strict new capital requirement should be set for the FHA's single-family fund, incorporated through a new actuarial model that accurately predicts losses.

Additionally, the budget treatment of FHA should be changed to reflect the fair-value analysis recommended by the Congressional Budget Office as it currently applies to the GSEs.

FHA is a critical market driver and source of taxpayer risk, but it is not the only force redefining U.S. housing finance. If reform to FHA or the GSEs is not well-balanced and pending rules are not carefully structured, we could well see creation of a set of new perverse Federal policies that force still greater mortgage market reliance on the taxpayer and, thus, still more risk, exacerbating our already dangerous fiscal situation.

Thus, I recommend that Congress should work to ensure that an array of pending prudential rules for banks—for example, those implementing the Basel III capital rules—do not so favor U.S. Government-backed mortgages as to block the reentry of private capital.

A critical pending rule would implement the risk-retention provision of the Dodd-Frank Act, creating a new Qualified Residential Mortgage (QRM) criterion that would exempt loans from risk retention. Although downpayment and loan-to-value ratio are key prudential factors, the QRM should not, as proposed, set a simple downpayment requirement without regard to the use of regulated, capitalized providers of credit risk mitigation like private insurers. Doing so would make it extremely difficult to securitize high-LTV loans for first-time home buyers and other borrowers who can prudently manage low-downpayment mortgages with careful underwriting backed by private capital at risk. If the QRM advances as proposed, these loans will flood into the GSEs and FHA, and once the conservatorships are closed, then only into the FHA.

In conclusion, private capital will only be attracted to the mortgage space when and if it becomes clear that the market has been reopened through the retreat of the government. One side of reform will only drive still more risk to taxpayers through FHA, an especially dangerous prospect given the many systems and risk management problems that have brought FHA to the perilous condition revealed in its most recent actuarial report.

Again, thank you for inviting me to participate in this vital discussion. I look forward to answering your questions.

[The prepared statement of Mr. Petrou can be found on page 64 of the appendix.]

Chairman HENSARLING. At this time, the Chair will recognize Ms. Gordon for 5 minutes.

STATEMENT OF JULIA GORDON, DIRECTOR, HOUSING FINANCE AND POLICY, CENTER FOR AMERICAN PROGRESS ACTION FUND

Ms. GORDON. Good morning, Chairman Hensarling, Ranking Member Waters, and members of the committee. I am honored and delighted to be here to testify today about the importance of the Federal Housing Administration in our mortgage market.

Since its creation in 1934, FHA has contributed to broadly shared prosperity in this country by helping tens of millions of families access homeownership. FHA doesn't directly lend money to home buyers, but instead insures the loans made by private lenders. In exchange for this protection, the agency charges both upfront fees and annual premiums.

FHA's model enables it to serve a crucial macroeconomic role, as well, because by providing reliable credit enhancement, it enables continued liquidity in severe credit crunches. It is essentially a shock absorber.

This role never been more important than in the wake of the recent housing market meltdown. When the bubble burst, privately funded lending essentially came to a halt and the government placed Fannie Mae and Freddie Mac into conservatorship. Access to credit tightened precipitously, throwing the market into serious imbalance.

In this difficult environment, lenders turned to FHA to help the market continue to function. FHA filled a gap left by the private market. It did not affirmatively seek market share. It is worth noting that the people who run FHA make the same amount of money whether they have a 3 percent market share or a 30 percent market share.

Since the beginning of the crisis, the agency has insured a historically large percentage of the mortgage market and, in particular, has served the home purchase market at a time when many other originations are refinancings. Right now, the housing sector is actually one of the brightest spots in the economy, and while the recovery does appear to be real, it is very fragile at this time.

FHA's countercyclical role over the past several years is more than a simple convenience for mortgage lenders or a slogan. Economists estimate that the liquidity provided by FHA kept home prices from plummeting an additional 25 percent. And remember, that is on top of the 30 or so percent that they already did drop. That kind of market collapse would have wreaked havoc, not just causing an untold number of additional foreclosures and decimating FHA's insurance fund, but also requiring far bigger taxpayer bailouts of Fannie and Freddie. Even worse, it is likely to have sent our economy into a double-dip rescission, costing up to 3 million jobs and half a trillion dollars in economic output.

As critical as it was to stabilizing the market, this support did not come without cost. FHA's insurance fund is not in good shape, and it is crucial that the agency takes steps to consolidate and improve its financial position as the economy recovers.

The finances, however, are not a reflection of a flawed business model but instead are a consequence of the 100-year flood of the great recession. The bulk of the agency's losses come from loans originated between 2007 and 2009, the years just before and after the $700 billion government bailout of the Nation's largest private financial institutions. That time period also included a large percentage of loans that used seller-funded downpayment assistance, an admittedly flawed program that cost the agency $15 billion in losses and without which the economic value of the fund would likely not be negative. In contrast, the agency's more recent books of business are likely to be some of its most profitable and safest ever.

FHA has taken a number of steps in the past few years to reduce risk and to strengthen the fund. They have raised premiums 5 times and instituted a variety of other risk management policies.

In addition, the home price rise over the past year will further improve the financial outlook. At this point, it would be prudent to hold off on additional price increases or additional changes in the credit box to avoid overcorrecting or making mortgages unaffordable for too many people. However, as these changes take effect, FHA can continue to improve their loss mitigation to avoid paying claims whenever possible. It should also continue to crack down on lenders who don't follow the rules.

But beyond FHA, the time is now to have a larger conversation about the future of our housing finance system. Fannie and Freddie cannot remain in conservatorship indefinitely, and a vibrant housing market cannot be built simply on refinancing. The market needs a steady supply of first-time home buyers who can then become move-up home buyers later. Many of these buyers will be people of color, young people with student debt, and other low-wealth but otherwise creditworthy families who don't have the means to put 20 percent down. As we consider what role the government should play in the mortgage market, we need to consider closely who will serve these borrowers.

I welcome the opportunity to discuss these important matters with you over the coming year. Thank you again for inviting me today, and I look forward to your questions.

[The prepared statement of Ms. Gordon can be found on page 48 of the appendix.]

Chairman HENSARLING. Dr. Sanders, you are now recognized for 5 minutes.

STATEMENT OF ANTHONY B. SANDERS, DISTINGUISHED PROFESSOR OF REAL ESTATE AND FINANCE, SCHOOL OF MANAGEMENT, AND SENIOR SCHOLAR AT THE MERCATUS CENTER, GEORGE MASON UNIVERSITY

Mr. SANDERS. Chairman Hensarling and distinguished members of the committee, thank you for the invitation to testify today.

Where do we sit now with the FHA? High-LTV loans, defined as 95 percent LTV and higher, currently stands at 71.52 percent. The FICO score buckets, which means the percentage of low FICO scores, which is 680 or below, is at 52.54 percent. These are very, very risky loans we are talking about.

And what I would like to do is point you to the colorful tables I have in my presentation. I just want to point something out on the risk of high-LTV/low-FICO-score lending or insurance programs. In 2007, in the 620 and lower FICO score and 97½ percent and above LTV, the serious delinquency rate was 51.6 percent. That means we are putting over half of the households into harm's way. It is like putting them in front of a bus. And a lot of them got severely injured.

But if we want to say, wait a minute, that was just that one year, flashback to 2001, before the bubble really hit, et cetera, 620 and below FICO and 97½ LTV and above was at 22.7 percent serious delinquency rate. That is one in four.

So, again, what I am saying here is that while the FHA has historically served a very notable presence in the market and has helped many American households get housing, it is also, by having the FICO score too low, throwing a lot of households under the bus, which is not great policy.

And one thing I just want to point out is that—so if we take a look at the FHA loan limit and what we can do to that, FHA of course has a higher loan limit than even Fannie and Freddie, their cousins. And I would say the first step is to shrink the FHA's footprint to allow entrance to the private sector by reducing the loan limit to 625 and then going at $100,000 a year until this is over.

According to a study by Robert Van Order, former chief economist at Freddie Mac, and Anthony Yezer at George Washington, they find that current FHA policies are unlikely to assist the FHA in reaching its historical constituencies—first-time, minority, and low-income households: "We find that FHA's current market share exceeds what is needed to serve these markets. In the wake of significant declines on home prices, we believe FHA could reduce its loan limits by approximately 50 percent and still almost entirely satisfy its target market," which I just mentioned. That will reduce its current market share, which is difficult for the FHA to manage. And David Stevens, the former FHA Commissioner, has said that exact same thing.

We need to put a floor on the credit score, as well, again, primarily to protect those households that are actually getting annihilated in default and foreclosure. So I would recommend a floor of anywhere from 630 to 660. A maximum LTV of 95 percent, at least, should apply. We are not talking 20 percent down; we are talking 5 percent down at a minimum, or a minimum downpayment of 10 percent if your credit score is below 680. Maximum debt-to-income ratio should be about 31 percent, should be put in there as well.

In summary, the FHA's low-downpayment, low-FICO policies with 100 percent guarantee, which is way too high, encourages risk-taking by working-class households when there is a viable alternative: renting. But simple adjustments to FHA's policies of a FICO score floor, a minimum downpayment of 5 percent, and a lower loan limit, going down from 625 down to 350 eventually or less, and a lower insurance coverage to, say, 80 percent instead of 100 percent, can improve the situation.

These are not draconian measures. These are simple fixes to at least help protect the first-time home buyers and minority programs. All these measures can serve to reduce the FHA's substantial high-risk footprint in the mortgage market and allow competition in the market to come back in.

Thank you for the opportunity to testify.

[The prepared statement of Dr. Sanders can be found on page 154 of the appendix.]

Chairman HENSARLING. Thank you, Dr. Sanders.

Thank you to all of our witnesses.

The Chair now recognizes himself for 5 minutes of questioning.

As chairman, I will tell you that it is going to be a priority of this committee to forge a sustainable housing finance system in America. And I mean "sustainable" in two different senses: number one, something that can help reduce the severity of the boom-bust cycle that has imposed such a cost on our economy and our hard-working families and taxpayers; and number two, something that is also sustainable for families. Again, the American dream was not to buy a home, it was to buy a home that you can actually afford to keep.

And so I have become concerned—and I think, Ms. Gordon, you used the phrase about the recent market meltdown, but I would remind all of us that the great debacle most people would date to September of 2008. It is now February of 2013. And I am again concerned that what were once extraordinary measures are becoming ordinary measures and becoming barriers to entry.

I am concerned about FHA having 56 percent of the market. And I know that in the February 2011 report to Congress entitled, "Reforming America's Housing Finance Market," the Administration stated that, "FHA should be returned to its pre-crisis role—and that was 2 years ago the Administration called for this—as a targeted provider of mortgage credit access for low- and moderate-income Americans."

So we will start with you, Mr. Pinto. How much progress have they made?

Mr. PINTO. Very little progress has been made, Mr. Chairman. While FHA says it has shrunk some, you have to realize that there are really three agencies that work in concert together under Ginnie Mae: FHA; the VA; and the Department of Agriculture. And their share has not changed very much because they have very large competitive advantages over the private sector.

So we have made very little progress. And we actually are in a situation where that progress could be turned back. Because as the FHFA Director increases the guarantee fees for Fannie and Freddie—Congress passed a law requiring that they be set at private capital rates—if FHA doesn't increase their rates in lockstep, then the business can just shift in the future over to FHA. So we still have a situation where the government has a hammer-hold on the market.

Chairman HENSARLING. Dr. Sanders, what do you see as the impediments for private insurance to fill the market? What are the precise practices of FHA that are helping them maintain this 56 percent market share?

Mr. SANDERS. I agree with Mr. Pinto. It is the conglomerate of not only the FHA but Fannie and Freddie. The market share is huge.

And right now, between Dodd-Frank and the Consumer Financial Protection Bureau and the endless mortgage put-backs by the same agencies that were involved in the National Homeownership Strategy, which caused the nightmare for American households, right now if I was lending or an insurer, I would be scared about going to the mortgage market, simply because you are going to get blamed for everything, particularly under the Qualified Mortgage (QM) rules that say all borrowers are now prime, and if any of them default, it has to be your fault.

So we have created an environment where FHA, Freddie, and Fannie, particularly the FHA, are just going to have, as Mr. Petrou said, an incredible market share. And we are kind of scaring people out of the market.

Chairman HENSARLING. I am going to try to set a good example here and keep myself to 5 minutes.

I just had my staff do a simple Google search, and I pulled up an ad called "MyFHA: FHA Mortgages." It is a private company, but listen to the verbiage here: "FHA Bad Credit Home Loans. Many people don't realize that FHA loans can help people with bad credit. Need a home mortgage but concerned about bad credit? You have come to the right place. An FHA mortgage can get you into a new home even if you have bad credit because the loans are insured by the Federal Government. If you have had accounts forwarded to collections, filed bankruptcy in the past, or have high debt, you still may qualify for an FHA mortgage. These loans can work for you even if you don't have much cash for a downpayment or closing costs. And they are a much better choice than the very expensive financing that banks call subprime." And the verbiage goes on.

I wish I had time to ask a question regarding that. I hope some of the other panelists will explore the serious delinquent rates you spoke about earlier.

At this time, I will yield 5 minutes to the ranking member.

Ms. WATERS. Thank you very much, Mr. Chairman.

One of the great things about this process are these hearings where we have an opportunity to straighten out the record, to present the facts, and to unfold what is really happening in many of these issue areas. And while we are in the Minority on this side and we only have one witness today, I think it is important that we clear up some facts.

Before I go on to the question, I would like to ask the chairman, did you say that the ad that you just read was by some unknown private business?

Chairman HENSARLING. The Chair said "private."

Ms. WATERS. I beg your pardon?

Chairman HENSARLING. The Chair said it was a private company.

Ms. WATERS. And so this was not an FHA ad soliciting anything; is that correct, Mr. Chairman?

Chairman HENSARLING. That is correct. The Chair—

Ms. WATERS. Thank you very much—

Chairman HENSARLING. —said it was a private company.

Ms. WATERS. —Mr. Chairman. I think we need to be clear about this.

Let me go on to a question that I would like to pose for Ms. Gordon.

The recent report released by FHA's independent actuary states that FHA's Mutual Mortgage Insurance Fund has an economic value of negative 1.44 percent, or $16.3 billion. But the fund's negative value is a future projected shortfall, not a current deficit.

The report also showed that FHA still has more than $30 billion of combined capital resources, and the manner in which the FHA's MMIF is calculated does not include future projected income.

Can you discuss some of the misperceptions about FHA's economic health and delve into the nuances of FHA's exact financial position and the meaning of the independent actuarial review?

Ms. GORDON. Sure, I would be happy to.

The negative economic value number is a number that says, okay, if we closed our doors today and didn't do any more business and had to pay out claims for the next 30 years, do we fall short? And the answer right now is we fall a little bit short. That is—if I had to look at my own balance sheet that way, trust me, I would fall short too.

Right now, FHA has plenty of cash to cover claims certainly for the next 7 to 10 years. And these new books of business are going to be extremely profitable. As home prices rise, losses decline. High foreclosure rates are a problem; I certainly agree with my colleagues on the panel about that. But from the point of view of the insurance fund, if in a foreclosure you sell a home and you don't take a loss, that is not a loss to the fund. So I think that is important to recognize.

It is also important to recognize that in its authorizing statute, Congress gave FHA the ability to draw from the Treasury in the event that they have to balance their books, as is required. That does not require any kind of congressional action. It is not a bailout by the taxpayers. You are essentially moving money from one account to another inside the—

Ms. WATERS. Thank you very much.

Dr. Sanders, do you realize that FHA does not insure loans over $729,750?

Mr. SANDERS. Yes, that is in my testimony.

Ms. WATERS. And is that available for the private market to take advantage of? They can have all of those loans over $729,750 if they want; is that correct, Dr. Sanders?

Mr. SANDERS. Technically speaking, that is correct.

Ms. WATERS. Whether it is technical or not, that is a fact. And they are not active in the private market while it is wide open to them, yet we talk about competition and we talk about them having too big a share of the market.

Let me also raise another question with you about how the loans are performing. Is it not true, Ms. Gordon, that FHA loans have been performing very well since 2010?

Ms. GORDON. Yes, new loans are performing very well. They are very safe. Average FICO scores for FHA borrowers right now hover around 700. These are certainly the safest books of business they have had in a long time.

Honestly, this is an example of government working for all of us to help the housing recovery, which is helping all of our neighborhoods and all of our mortgages, whether or not they are insured by FHA.

Ms. WATERS. Thank you very much.

I suppose my time is almost up, so I am going to be as generous as you were and yield back.

Chairman HENSARLING. Leading by example, as well.

The gentleman from California, the vice chairman of the committee, Mr. Miller, is recognized for 5 minutes.

Mr. MILLER. Thank you, Mr. Chairman.

I want to say that FHA has played a very important countercyclical role in the process, providing liquidity. We have been in a very distressed marketplace.

Mr. Sanders, I agree with you—I have been a builder for over 40 years—that the private sector has actually been scared out of the marketplace by the Dodd-Frank Act.

And I probably would disagree with all of you on certain things, but, Ms. Gordon, I had some real concerns in your testimony. You conclude your written testimony today saying it is important to give sufficient time to see the results of internal reforms recently instituted by FHA. That is a correct statement?

Ms. GORDON. Yes. I think a lot—

Mr. MILLER. Thank you. I appreciate that. But I heard the same thing from FHA in 2009, 2010, 2011, and 2012. They said the very same thing when they testified before Congress.

The problem I have is, when I look at the actuarial projections that you based your testimony on, in 2009 we were told they were 0.42 percent-plus at that point in time. We were told that by 2012 they would be at the congressionally mandated minimum of 2 percent. Is that not a correct statement?

Ms. GORDON. That is correct. And I think—

Mr. MILLER. Thank you. And in 2010—

Ms. GORDON. —there are a lot of things that have not gone—

Mr. MILLER. That is it.

Ms. GORDON. —the way we thought.

Mr. MILLER. I am going to ask you some questions.

In 2010, they were at 0.59 percent. We were told that by 2011, they would be at 1.75 percent. Is that not a correct statement also?

Ms. GORDON. Correct.

Mr. MILLER. And in 2011, they were at 0.12 percent, not 1.75 percent. We were told that by 2012, they would be at 1.5 percent. Is that not a correct statement?

Ms. GORDON. Correct.

Mr. MILLER. They were actually at 1.28 minus, which means there is a 2.75 percent difference in what they projected every year based on what they have done and the reforms they have undertaken.

Now, I agree that FHA has been a shock absorber for the economy, but it has kind of been broken. The shock absorber doesn't appear to be really working.

I also agree that real estate is probably one of the bright spots in the economy today, because I am doing building in some States and I see the market coming back. But that doesn't change the fact that FHA is undercapitalized. Every projection they have made by the actuarial and their data that they have, that they have given them, has been wrong.

And the problem I have is, yes, I agree that much of the losses, the major losses, occurred in 2007 and 2008, probably in 2009, in that era—I think they might have gone back to 2006 when they started. But they have not done what is necessary to keep themselves in the plus column, and that is taking in and analyzing the risk that they are taking on certain loans and making loans that would offset the losses that they know they were going to take.

And if we would have had any bank in the economy or mortgage industry group out there, we would have closed them down and taken them over in year one. But by the projections I see by the actuary, we are talking about 8 years. We are going to forego what we required every private sector lender out there to undergo by the Federal Government, being closed down 1 year, we are saying, well, that is okay, but we are going to let you go 8 years.

And so the problem I have, even though I support what they have tried to do to stabilize the economy, in your testimony you say that we should not be worried because a projection by the FHA actuary is that the capital reserve ratio will be positive by 2014 and will reach a statutory minimum of 2 percent by 2017.

And I am not trying to impugn you, but I am impugning somebody. Because what they are telling us is to sit back and hope—hope it is going to happen, hope they are going to be right this time even though they haven't been right in the previous 4 years. Vince Lombardi was really great. He said, "Hope is not a strategy." And I am unwilling as a Congressman, as much as I support the housing industry, as much as I love the industry—I have been involved over 40 years; I see it recovering—but I can't sit back here with taxpayers' dollars and say, well, I hope they are right this time.

From 2011 to 2012—we were told in 2009 they had modified the structure of the FHA so you would not face these downturns. And we went from 0.12 in the plus to minus 1.28 in the negative in 1 year. Now, the problem is I don't know what has happened since 2012 to 2013. Did we go down another 1.28 percent?

My time has expired. And I was not attacking you, but I was attacking what you were working under—

Ms. GORDON. May I briefly respond?

Chairman HENSARLING. The time of the gentleman has expired.

The gentlelady from New York is now recognized for 5 minutes.

Mrs. MALONEY. Thank you.

During the economic crisis, my constituents were telling me that it was impossible to refinance a mortgage, it was impossible to get a mortgage. I had distinguished businesses and businesspeople come to me and ask, why doesn't the Federal Government open up a bank so that we can get a loan for a home?

So I would like to ask Ms. Gordon, what economic effects would we have witnessed if FHA closed down and stopped insuring new loans immediately following our recent economic crisis?

I would like to add that many members of the panel say that the private sector wants to step in. Well, step in. Finance it. FHA came in during a crisis and provided a stop-gap support for housing that others were not willing to do.

So, Ms. Gordon, your response, please?

Ms. GORDON. Thank you for that question.

The fact is, whether the fund is $1 billion up or $1 billion down, this is a bargain price for what the FHA did to stabilize the housing market and the economy. We are talking billions, if not trillions, more that could have been lost if we had not had this liquidity available to us.

I am very glad to see that Congressman Miller understands the role that has been played, but when we think of the $700 billion bailout of those private institutions, which clearly were far worse at pricing risk than the government has been—in fact, they thought they had magically eliminated risk—we have really seen government at work here on behalf of all of us.

Mrs. MALONEY. I would like you to comment on a statement that Secretary Donovan made before this committee last year. In it, he was quoting findings from Moody's. And he said that the loss of FHA in 2010—if FHA had not been there in 2010, the loss would have meant the loss of 3 million American jobs and a 2 percent decrease in our GDP.

Would you agree with his statement on that and Moody's statement on that, on their role?

Ms. GORDON. I would absolutely agree with it. This is FHA playing the role that was intended from the beginning. The Act establishing FHA did not limit FHA just to a particular set of buyers or a particular kind of loan. It was there to backstop the housing market.

Mrs. MALONEY. And in your testimony you spoke about this, but I would like you to elaborate on the countercyclical role FHA has played since the financial crisis began in 2008. You mentioned in your testimony that FHA has been as low as 3 percent in times of great prosperity, but in times of crisis it steps in to fill the gap because the private sector is not there.

Could you elaborate on the countercyclical role it plays?

Ms. GORDON. That is exactly right, that FHA was available to provide the liquidity that people needed both to refinance their homes and, most importantly, to buy homes. Because when people are going through foreclosures or leaving their home, someone has to be on the other end to buy that home to keep the neighborhood stable and keep the market functioning. So that was so important about this role.

As to the question of market share, there are a variety of steps, some of which FHA has already taken and, I agree with my colleagues on the panel, can be taken to maybe help crowd in private capital, as people talk about. But at the moment, if you look across Fannie, Freddie, and FHA, it is going to take a lot more to "crowd in" private capital.

Private capital is sitting on the sidelines not just because of some CFPB rules and not because FHA is so cheap, because it is actually not that cheap to get an FHA loan, but because there is enormous uncertainty about what the long-term future of housing finance in this country looks like. And that is why it is really important that we soon have the conversation about the future of Fannie and Freddie and the future of FHA and what kind of housing policy we want to have.

Mrs. MALONEY. You have mentioned steps that could be taken. What steps is FHA taking in terms of improvements to risk management and fee increases to help mitigate the changes we have seen in the market?

Chairman HENSARLING. I am sorry. If you could summarize. There are only 10 seconds left.

Ms. GORDON. Sure. There have been five premium increases, as well as a number of other policy changes.

Mrs. MALONEY. Thank you. My time has expired.

Chairman HENSARLING. The Chair now recognizes the chairman emeritus, the gentleman from Alabama.

Mr. BACHUS. Thank you.

I would say to both the Members and to the panel, Ms. Gordon is right when she says the role of FHA originally was different from what it is now. In 1934, when it was formed, 60 percent of Americans did not own their homes and you could only have a mortgage for 3 to 5 years. And then in the 1940s, it was primarily used for affordable multifamily housing. So, it has evolved.

But I don't think there is any disagreement—I think Ms. Gordon would agree—that the present mission, even if you look on the official Web site, is to provide mortgage insurance for low- and middle-income American families for affordable housing and for multifamily housing. Now, we sometimes forget that multifamily housing. And I know Chairman Frank and I have both said that is a very important role and it is a profitable role, providing financing for private apartments.

The present mission—and I would ask the panelists—as I understand it, is there is pretty much agreement on low- and middle-income mortgages, other than multifamily, for creditworthy families. And we sometimes forget that "creditworthy."

Now, having said that, where are these loans being made? They are primarily made in two areas. They are primarily made for people of higher incomes. You can look at Mr. Pinto's and Dr. Sanders' testimony. They are cross-subsidizing and loaning—I think the figure is 54 percent of its activity in 2011 was for 125 percent of an area's median income housing, so above—and, actually, 63 percent of FHA borrowers in high-income areas had greater than 150 percent of the average median income.

So, they are doing that. The reason they are doing that is they are making money on that, which is subsidizing another category—I read Mr. Pinto's testimony and what he said earlier. Don't miss this. Forty percent of FHA's business consists of loans with either one or two subprime attributes: a FICO score below 60, below 60—that is bad credit—or a debt ratio greater than or equal to 50 percent. Now, those are risky loans.

So my question for Mr. Pinto, Dr. Sanders, and any of the panel: These loans to high-income Americans and to families with FICO scores of 60 or below or debt ratios which are subprime category, is that the mission of the FHA?

Mr. PINTO. I think it is not FHA's mission to serve higher-income individuals and higher-priced homes. FHA's mission should be focused on working-class neighborhoods, first-time home buyers.

And what I have suggested in my testimony is that if you establish a tolerance for failure of FHA around 5 to 6 percent, you can re-target FHA to that group and successfully price those loans and still have money left over so it doesn't negatively impact FHA's fiscal position, which is poor; we just don't want to make it any worse.

The reason for this is, as my study has shown, once you get around 10 percent—and remember, that is the history of FHA over 37 years. That is why we have the 3.25 million foreclosures in 37 years. It is because FHA has been tolerating an 11 percent foreclosure rate year-in and year-out, on average. So if you have that 11 percent foreclosure rate, you end up having neighborhoods, thousands and thousands of them—we found 6,000 zip codes where the foreclosure rate averaged 15 percent. And that is financing failure in those zip codes and destroying those neighborhoods.

Mr. BACHUS. All right. So both of those categories that I talked about are really somewhat of a departure from their mission; is that correct?

Mr. PINTO. Absolutely.

Mr. BACHUS. And Dr. Sanders?

Mr. SANDERS. Oh, absolutely. I think the FHA has veered dramatically from its original mission. In fact, based on the Web site Mr. Hensarling found, I think they ought to put a little asterisk there saying, "Low-FICO, high-LTV loans have between a 25 and 50 percent chance of serious delinquency. So you might want to think twice—"

Chairman HENSARLING. The time of the gentleman has expired.

Mr. BACHUS. Thank you.

Chairman HENSARLING. The Chair now recognizes the gentlelady from New York for 5 minutes.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Mr. Pinto, isn't it true that FHA has stringent standards related to borrower qualifications and credit scores?

Mr. PINTO. Than prior?

Ms. VELAZQUEZ. They are talking about—I believe the previous Member asked you if they will provide—

Mr. PINTO. We have this bifurcation that leads to an average. So, on one hand, FHA has very high-income, very high-home-price, and relatively high-FICO-score borrowers. And they make loans to those borrowers, and they use those moneys to subsidize the borrowers who are below—the subprime borrowers who were mentioned, the 40 percent of borrowers who have FICO scores below 660 or debt ratios above 50 percent. That is what is going on here.

Ms. VELAZQUEZ. Yes.

Ms. Gordon, I would like to hear from you.

Ms. GORDON. First of all, I think it is interesting that sometimes Mr. Pinto likes averages when he is talking about the foreclosure rates, but sometimes he doesn't like averages when he is talking about FICO scores.

But that said, I think what we have to do here is we have to distinguish between what I like to call "risky borrowers" versus "risky loans."

The reason we had a housing crisis was because of risky loans and risky lending practices. People in the neighborhoods that Mr. Pinto has identified, those neighborhoods were largely targeted and in some sense, terrorized by these exploding ARMs, negative amortization loans, loans that were push-marketed to people without including escrow in the monthly payment. These were terrible products that were designed to fail.

FHA provides 30-year, fixed-rate, fully underwritten mortgages. These are not risky mortgages.

Ms. VELAZQUEZ. Thank you, Ms. Gordon.

Mr. Sanders, in your testimony, you suggest reducing FHA's loan limit by 50 percent over the course of the next few years. However, the average home prices in high-cost urban markets like New York are far above $350,000 and continue to grow. Your recommendation will price first-time and low-income buyers out of the market.

How can FHA fulfill its mission if it cannot provide loans to first-time home buyers and low-income families in high-cost housing areas?

Mr. SANDERS. Thank you.

On this score, I agree with Shaun Donovan, the Secretary of HUD, who believes that we should be building more multifamily projects in the city to help relieve that stress so we have people with sensitive credit who can actually live in clean multifamily housing. I think that is an excellent public policy goal.

Ms. VELAZQUEZ. Ms. Gordon, could you please explain to the committee that the median home sale price in places like Brooklyn, New York, is $565,000. And I suspect in areas like Boston and San Francisco, that would also be the case. In Chinatown, the median average is about $1 million.

FHA's products allow low-income borrowers and first-time home buyers to obtain affordable financing options to purchase homes in these and other high-cost areas. What will happen in these communities if FHA reduces loan limits, as suggested by some of the other panelists?

Ms. GORDON. It is an anomaly right now that the GSEs have lower loan limits than FHA. That is an odd arrangement of the world. And I understand Congress made that choice, but I am not sure people quite understand that.

But what is important to understand now is that this housing recovery is both crucially important to us right now and very fragile. So to the extent we move, we need to move slowly, and we need to move carefully.

And I would love to see private capital come back into that space. They can come back into that space. The reason FHA used to have such a low market share is because private capital had no trouble competing. FHA mortgages are cumbersome, there is a lot of paperwork, there is a lot of stuff you have to go through. It used to be that private mortgages were more attractive to most people when they could get them. So if the private market comes in, FHA will be able to retreat.

Ms. VELAZQUEZ. Thank you.

Thank you, Mr. Chairman.

Chairman HENSARLING. The Chair now recognizes the gentleman from California, Mr. Royce, for 5 minutes.

Mr. ROYCE. Thank you, Mr. Chairman.

I think as we look at the overarching goal here, it is really to get private capital back in, right? And at the same time, we are concerned about the bailouts and the likelihood of a major bailout here if we go in the wrong direction.

We had in 2009, and we had in 2011, testimony from the head of HUD and from the FHA that they were going to work to improve the financial footing. The way they were going to do it was HUD decided to allow FHA to expand, rather than to ask it to be recapitalized at that point.

So we are headed in a direction, but what has the result been? The consequences of that expansion has—we have gone from, what, a positive $4.7 billion 3 years ago to $2.5 billion in 2011, to a negative $16.3 billion in 2012.

I was going to ask Mr. Pinto—we talk about the enablers here of overleverage in the system. We are all concerned about what was done in the past to overleverage. You have heard me argue in the past about 10-to-1 leverage being the maximum we should allow. We had Bear Stearns at 30 to 1. That is a problem. But in November 2011, we had FHA at 422 to 1. I remember when Fannie Mae and Freddie Mac were discovered to be 100-to-1 leverage, we thought we had a problem.

So, clearly, going forward, we have something we have to address here. And now that the FHA has a negative economic value, I don't know how you even compute leverage. I don't think you can with a negative denominator for capital.

Are there other accounting means that we can use to compare FHA to other public- and private-sector entities? I will ask Mr. Ed Pinto on that. And under any mechanism, is the FHA solvent? Does this raise the prospects, frankly, for us to be concerned about a future bailout here, given the way that this graph shows actual versus projected over the last couple of years?

Mr. PINTO. Okay. Thank you, Mr. Royce.

I don't know of any accounting regulatory scheme that would lead FHA to have a positive net worth. What is used by the actuarial study is what is known as government accounting principles. Back in 1984, when someone who worked for me was talking about government accounting principles, they said, "They are neither accounting nor principles. They are not based on anything that you can get your arms around."

Generally Accepted Accounting Principles (GAAP), which are used in the private sector—I have been reviewing FHA every month for over a year using generally accepted accounting principles. And based on that, FHA has a negative $25 billion net worth today, and it is also short $22 billion in its capital requirement as established by Congress, so for a total negative of over $45 billion.

That is where FHA is today. And where it is going to be tomorrow—Ms. Gordon talks about how they would like to count future income and things like that, future business. No financial institution in the world gets to count things the way FHA counts them.

Mr. ROYCE. Let me ask Mr. Sanders, then, because in your testimony you laid out a series of steps that could improve the financial soundness and would also reduce the market share, including: improve the credit quality of those receiving insurance; increase the minimum downpayment; and reduce loan limits.

Can some of these steps be taken by the FHA under its current authority? And of those requiring congressional action, how would you prioritize which we should tackle in Congress? But, first, let's take what could be done under the current authority.

Mr. SANDERS. Under the current authority, they can do things like disclose information better. The FHA is almost like Communist China in terms of reporting their loan level data; we just don't do it. That would help us get around the problem that was asked of Mr. Pinto on accounting. Just show us your books. The actuarial reports are just—whether grossly misleading, I don't know, but they are just—

Mr. ROYCE. Reducing loan limits?

Mr. SANDERS. I think reducing loan limits has to be done here. I don't think they can do that themselves.

Mr. PINTO. Let me just say two things that FHA could do immediately that would be huge.

Number one is, they threatened a 3 percent limitation on seller concessions, David Stevens, 2½ years ago. It has not been done. I think one of the Members said it had passed; it has not taken place.

And then, number two, return appraisal panels, just like the VA does. Those two things would be huge.

Mr. ROYCE. Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlemen from North Carolina, Mr. Watt, for 5 minutes.

Mr. WATT. Thank you, Mr. Chairman.

And let me start by thanking the chairman and the ranking member for having this hearing. I think it is critically important, and it is an important first step to getting to the basis of what we need to do in this committee not only about FHA but Fannie and Freddie. And if we don't find some good answers, housing in this country is going to be even worse and homeownership is going to be an impossibility, I think, over time.

I assume there is nobody on this panel who believes that we don't need FHA, is there?

Oh, there is somebody. Mr. Pinto.

Mr. PINTO. I think that raises the question—

Mr. WATT. Either you do or you don't, now.

Mr. PINTO. Let me just answer it.

Mr. WATT. Don't—

Mr. PINTO. If you don't take steps to reform FHA, there is an alternative way to get to the kinds of housing assistance—

Mr. WATT. Okay. But the mission—

Mr. PINTO. But if you don't fix it—

Mr. WATT. Let me rephrase the question. The mission of FHA—is there anybody on the panel who believes that we should not have the mission of FHA if FHA is operating within that mission? Is there anybody who—

Mr. SANDERS. The original mission?

Mr. WATT. Yes, the original mission.

Mr. SANDERS. I have no problems with the original mission.

Mr. WATT. All right. Okay. So the problems we are having is, it sounds to me like you believe that FHA is operating outside the mission. And part of that has been as a result of the private market fleeing for whatever reason. So one question I have is, how do we get the private market to step back into this space that FHA is inappropriately, you believe, in?

Let's talk about that for a little bit. And I would love to have Ms. Gordon's opinion about that. I would love to have Mr. Pinto and Dr. Sanders' opinion about it. Because if the private market is not going to step into the space, either we are not going to have the space occupied or Fannie is going to occupy it or Freddie is going to occupy it or FHA is going to occupy it, all of which currently expose, potentially, taxpayers.

How would you attract the private market into this, Ms. Gordon? And then, Mr. Pinto and Dr. Sanders?

Ms. GORDON. It is going to be important to have the larger conversation all together. You can't just address FHA in a vacuum, if we really want to fix the housing market going forward.

We have to get serious about what we are doing with Fannie Mae and Freddie Mac. They are showing a profit now; they have become a convenient piggybank. But the fact is we have to address the whole thing together so that we can appropriately—

Mr. WATT. Okay. All right.

Mr. Pinto, go ahead.

Mr. PINTO. I agree with Acting Director DeMarco: "The road to housing finance reform starts with FHA. You have to define the role of FHA." If we define—

Mr. WATT. Well, we have agreed on the mission, the original mission. How do you get—

Mr. PINTO. Right. So then you—

Mr. WATT. How do you get the private market to come back in beyond that mission?

Mr. PINTO. The private market is ready, willing, and able. You have new mortgage insurance companies that have started. You have capital being put in—

Mr. WATT. What are they waiting for?

Mr. PINTO. Excuse me?

Mr. WATT. What are they waiting on? Why are my constituents coming to me saying, "I can't get the private market to finance a loan?" What are they waiting on? That is the question I am trying to get to.

Mr. PINTO. You want responsible lending. I think we all want responsible lending. And the private sector is ready, willing, and able to do responsible lending. FHA, as I have documented, is not doing responsible lending in these areas that are occupied—working-class families and neighborhoods. They are not doing responsible lending. You want responsible lending.

Mr. WATT. Dr. Sanders, go ahead.

Mr. SANDERS. I agree with Ed. Part of the reason, although Ms. Gordon doesn't agree with me—

Mr. WATT. I am not looking for reasons. I am asking, how can we attract private capital back into this area? I am not looking to blame anybody. I know what the blame is. We have been doing that for 2 years now.

Mr. SANDERS. I am not blaming Ms. Gordon. I am just saying that—what I think is, if we take a look at the Dodd-Frank Consumer Financial Protection Bureau QM, whereas essentially, as I have called it before, is the Fannie-Freddie-FHA protection bills, because now most loans are just going to go to FHA once Freddie and Fannie come out of conservatorship. And so, we have to lower the footprint, raise the premiums even more on FHA, and, again, take them out of the subprime end of the market.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from West Virginia for 5 minutes.

Mrs. CAPITO. Thank you, Mr. Chairman.

I want to thank the panel.

I would like to start on the shortfall at FHA, the $16 billion that we have talked about, capital ratios in the negative. And I believe I heard Ms. Gordon say—and I haven't been in the entire hearing, so excuse me if I have misconstrued your comments—that basically what it would be is, if it was ever called upon, is just shifting from one account to the other and that there is really nothing that the taxpayers would be liable for.

Is that your essential statement there?

Ms. GORDON. No, that is not what I am saying. What I am saying is that right now, there is nothing that is going on that requires what I think people think of as a bailout, where Congress has to vote new money to do something that wasn't contemplated.

What is happening right now is contemplated, that from time to time an agency with a mission like this is going to be in dire straights.

And don't misunderstand me. These are financial dire straights, and it is very important to get the financial house back in order through steps such like the ones that FHA has taken and some of which they are seeking additional congressional authority so that they can take.

Mrs. CAPITO. Right. But if there is an infusion from the Treasury, that would, in fact, impact taxpayers, because the Treasury is and continues to be our tax dollars. Correct?

Ms. GORDON. Yes.

Mrs. CAPITO. Okay.

Then my next question would be to the experts on the panel. Is there a mechanism that if an infusion of capital from the Treasury becomes necessary, which it looks like it might be, is there a mechanism for FHA in rosier times to repay this as part of the process?

Mr. PETROU. Yes, there is. The key is to, first of all, change the budget accounting, which is what CBO has recommended, to show the true risks associated with FHA. All these numbers that you are talking about are numbers that are really artificial, and they are artificially low in terms of the bailout that we are talking about.

Mrs. CAPITO. So you think the $16 billion is a low figure?

Mr. PETROU. It is low in terms of the real risk, and that is—

Mrs. CAPITO. Okay.

Mr. PETROU. —what CBO has made clear in its work with respect to fair-value accounting.

The second thing, the way you want to—if you are going to grow—you can't—I don't believe in growing FHA's way out of its problem. I think that is really just what the S&Ls thought they would do in the early 1990s, and it failed, but now you are playing with taxpayer money.

The answer, really, as I indicate in my testimony, is to cut the government insurance down to 30 percent from 100 percent—

Mrs. CAPITO. I see.

Mr. PETROU. —so that the lender is on risk, and then keep the premiums so that you can recapitalize the fund to 4 or 5 percent. And that way, you would start getting yourself into a responsible economic program, as opposed to worrying about supporting the market—if, in fact, it needs the support, continued support—by inflating home prices.

Mrs. CAPITO. All right. Thank you.

I am going to jump to another area here because I only have a minute and 45 seconds left.

I was the ranking member on the Housing Subcommittee with Ms. Waters when she was the Chair, and we had more than a few meetings of this impending doom. This has been talked about in our committee for years, that this is the direction the capital ratio is headed.

The response from the Secretary of HUD and others, the FHA administration, has always been that the newer loans, the ones that are being entered in now, are going to be the ones that are going to sustain the fund going forward and that the past ones are the ones that are really messing it up, and that all these loans are going to be cycled through. But from what I am hearing from your testimony, that is not what is happening here.

Mr. Pinto, would you have a response to that?

Mr. PINTO. Yes. You are absolutely correct. What is going on here, these projections are made, and they are just not credible.

The projection itself that was made in November is based on a July interest rate projection. In the report, it talks about, if we are in a low-interest rate environment—and I think everyone here agrees we are in a low-interest rate environment—it is not $16 billion negative or $15 billion negative, it is $31 billion negative.

Secondly, the last recession ended in mid-2009. It doesn't feel like it ended, but officially that is when it ended. FHA is very vulnerable to a recession, as the chairman said at the beginning, very vulnerable to a recession. If there were to be a recession anytime in the next 4 or 5 years—and I am not talking about a big one, just a normal, run-of-the-mill recession—FHA would suffer catastrophic losses and the taxpayer would be at risk.

Why? Because not only do they have all these negative economic values we have talked about, then they run into some additional losses that they never projected.

Mrs. CAPITO. All right. Thank you.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Thank you.

The FHA may have mispriced risk, but I will point out that the private sector did worse. S&P stood as the crown jewel of the private sector's ability to price risk. They were in the business of telling everybody else in the private sector what the risk was. And now, a judge or jury will determine only the simple fact: Were they negligent in mispricing the risk or fraudulent in mispricing the risk?

In 2010, this committee and the Congress passed legislation that pushed the FHA toward higher fees. Now, it appears that they are doing a better job of pricing risk—if anything, pricing it high enough to make a profit.

Last December, the Secretary of HUD testified that FHA's market share was contracting. I want to recognize the gentlelady from West Virginia, because she and I worked on a letter that I think was important in prodding the regulators to define qualifying mortgage with a safe harbor. Now that they have a safe harbor—and let's hope that concept is made solid—I don't know why the private sector is not playing a more robust role.

Ms. Gordon, you testified that there would have been another 25 percent decline in home prices if FHA had not been in the market. I think that comes from Moody's? And you are nodding "yes."

In a few sentences, could you tell us what this country would have looked like if we had had another 25 percent decline in home prices? Or do I have to watch all those post-apocalyptic movies?

Ms. GORDON. Yes, I would say you have to watch one of those movies with all the scary things, because I—

Mr. SHERMAN. "Thunderdome?"

Ms. GORDON. —can hardly imagine. There are so many neighborhoods that still are in deep, deep distress because of the private, toxic, subprime loans that were made and because of the foreclosures, the subsequent recession, the unemployment. Imagine if we had had 3 million fewer jobs—we would not be on a road to recovery today at all.

Mr. SHERMAN. For the record, I will just define your answer as "somewhere between 'Grease' and 'Thunderdome.'"

Ms. GORDON. That works.

Mr. SHERMAN. I worked with the Vice Chair of this committee to allow FHA in high-cost areas to go as high as $729,750. That sounds like too much for most of the districts represented here, but in the 12 high-cost areas, it was critical.

Are the FHA's reserves higher? In effect, are they making a profit, an actuarial profit, on those loans that they are guaranteeing between $625,000 and $729,000?

Ms. Gordon?

Ms. GORDON. I don't have the numbers in front of me, but one would imagine that is a possibility. Maybe Mr. Petrou has the number.

Mr. SHERMAN. Mr. Petrou?

Mr. PETROU. I would question whether or not that is the case. And the reason I question it is that, while FHA had hoped that its 2010 book of business, for example, would be performing better, hopefully enough to bail out the rest of the fund, in fact, if you look at the latest actuarial report, you will find that the present value of that book of business is falling.

Mr. SHERMAN. I would beg to differ with you on a couple of points. First, I was asking about loans that make up about one-twentieth of that book of business.

Mr. PETROU. Yes, and that is where you get—

Mr. SHERMAN. You are talking about what the temperature was in the whole country, and I asked you what the temperature was in one county.

Mr. PETROU. And that is—I said my—

Mr. SHERMAN. So I am going to reclaim my time and just note for the record that in terms of default rates, private-sector loans, prime, have been at 5 percent; subprime, 22 percent. Yes, the FHA overall is at 9 percent, but for those loans made in 2011, the seriously delinquent loans are only 3 percent.

So to say that the FHA's recent loans—first of all, you have the actuarial value that says that their book of business for 2010, 2011, and 2012 should raise their capital by $22 billion in profit, but then you have the actual nonprojected, real-life experience of 2011, a 3 percent default rate.

And I believe my time has expired.

Chairman HENSARLING. It is certainly expiring.

The Chair will now—

Mr. SHERMAN. It is clearly expiring.

Ms. Gordon, do you have any further comment in 5 seconds?

Ms. GORDON. What we can all agree on is if we do a better job of loss mitigation, both at FHA and elsewhere, that will help everybody's books.

Chairman HENSARLING. The Chair now recognizes the gentleman from New Jersey, Mr. Garrett.

Mr. GARRETT. Thank you.

And before I begin, just to this issue of where the private sector is versus these that are basically in the public sector, remember, those loans that are in the private sector, if they go bad, the taxpayer is not on the hook. So if they made bad decisions on these things, it is not the taxpayer who ultimately has to pay the price for it.

But on to this panel. This panel has been interesting in some of the rhetoric that we have heard so far, that we have heard from some members, at least Ms. Gordon, using the term "terrorism" in the financial sector, that people have been terrorized, areas have been targeted, and what have you. I suppose that some of the government policies that also went after the low-income in these certain areas, such as CRA, might be government counterterrorism in those same areas, as well.

But rhetoric aside, I think the other term that we hear from the other side, the constant refrain or the mantra of the countercyclical role of the FHA is an interesting one. I guess that means that if you, individually, would not lend money to your neighbor to help them buy a home because of market situation or what have you, but you want the government to use taxpayers' dollars to go in and help them out and buy a loan, that is the countercyclical nature of the FHA; something that you, individually or personally or investment-wise, you are not willing to do, but you are sure happy to have the taxpayer step up and step into that role. And that is the role you are suggesting for the taxpayer through the FHA.

Now, notice that when you do require the FHA to take that countercyclical role, there is a price to pay, not for the prudent borrower, not for the individual who has said, "During these down times, I am going to wait and save up my money to get into the market tomorrow or the next day," because when you act in this countercyclical manner that the FHA has done, what happens is, as this panel has indicated, the rates later on, as they are now, as Ms. Gordon has said as well, the costs go up.

So that prudent individual actually has to pay the price for the failed policy of the Federal Government and also for the imprudent action of the prior borrower, who now finds himself either out of a house or in a house that is underwater. I am not sure why anyone would be advocating for imprudent investments and imprudent lending or for penalizing those individuals who do the appropriate thing and buy when they are able to afford it.

Let me turn to Dr. Sanders as to what the appropriate role for the FHA is, since you said you approve of the appropriate historical role of the FHA. And that was, I believe, to help out first-time homeowners and those low-income communities and areas or individuals who could not afford to buy a home, and FHA was created in that manner.

Just as an aside, I know our President has been on TV frequently defining who the rich are in this country, and the rich are anybody who makes over $250,000. So those are who are the rich. But isn't that exactly what the FHA has now morphed into, is saying that we are now going to allow and to help facilitate those rich people to buy homes?

Mr. SANDERS. Yes, the FHA has strayed from its original mission: first-time home buyers and minorities.

And even on the minorities side, you have to be very careful about harming. Again, FICO score gets too low, they are actually worse off—not all of them, but maybe 50 percent are worse off going into this homeownership under the new rule, the revised thing. This is not helping; this is hurting.

Mr. GARRETT. Let's drill down on that a little bit. What we think, on the face of it, is actually helping communities and helping homeowners is, what? Is actually hurting them, because it is helping to facilitate people buying houses that they can't afford in a downward market, putting them into houses that are soon going to be underwater. And, actually, now, you are also adding the other facet that I didn't think about: That actually gives them a lower FICO score going forward if they need to get out of this or buy something else.

Is that what you are saying?

Mr. SANDERS. Yes. I never think it is proper housing policy, or any kind of policy, to encourage households to take on a lot of risk, which is exactly what the FHA is doing when they strayed from their original mission. And, of course, that ended catastrophically in history.

And, by the way, saying, going forward, the book looks good now may be true, but, remember, everyone was saying back in 2002, the book looks great, everything is improving. Well, it didn't. We still had for those low-FICO 25 percent serious delinquency rates.

The problem is that you can't just look at the current state and assume that is the future. We will have other recessions, as Ed said.

Mr. GARRETT. Mr. Pinto, I see you are raising your hand.

Mr. PINTO. Yes. The NAR—and, in fact, they just took out ads, full-page ads today. And they say that FHA provides access for credit for millions of Americans exactly the way Congress designed it to operate 80 years ago. So I went back and looked. Eighty years ago, the maximum LTV was 80 percent; today it is 96½ percent. The maximum loan term was 20 years; today it is 30 years. Insurance claim rate, 0.2 percent cumulative over 20 years, versus 11 percent annual now. The loss rate has increased 400 times—400 times.

Mr. GARRETT. Thank you. Those are important points. I appreciate them all.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair is going to make an announcement. As you probably know, votes are anticipated on the Floor shortly, perhaps as early as 11:00. With the agreement of the ranking member, we will clear one more Member on each side and adjourn at that point. And I understand the Democrats have their retreat today, so we we will not be gaveling back in.

So, at this point, the Chair will recognize the gentleman from New York, Mr. Meeks. And with apologies to everybody else, you can probably do the math and figure out whether or not you are going to be recognized.

The gentleman from New York?

Mr. MEEKS. I want to thank the chairman and the ranking member for this time and for this hearing.

Let me just ask a few quick questions. I know that the ranking member of the Housing Subcommittee is champing at the bit over here, and so I am going to try give him a couple of minutes, at any rate.

But I just heard—Mr. Sanders, you stated and you have quoted in some of your testimony, I guess, this question about the policy or the mission of FHA and that it no longer can serve first-time buyers or minority and low-income borrowers.

But isn't it true that in 2011, over half of all African Americans who purchased homes purchased an FHA mortgage and over 49 percent of Latinos did so with FHA financing, as well as 78 percent of all FHA finances were first-time home buyers? Isn't that the mission of what FHA is all about, and, therefore, they are continuing that original mission?

Mr. SANDERS. Mr. Meeks, thanks for asking me that question.

First of all, I did not say they are not doing first-time home buyers. But, second, I have that table in my testimony, that, in fact, the FHA does serve more Black and Hispanic households.

My point is that, while that may be true, do we really think, again, throwing them in front of a moving bus, where the delinquency rates are so high, is that proper public policy? Or are they better off doing what Shaun Donovan, the Secretary of HUD, said?

Mr. MEEKS. Just what we just said before, under those same time periods, if you look at the delinquency rates, it is down. In one year, it was 6 percent, and in the other, it was 3 percent.

And then in your same testimony you talked about the fact that—and you used the D.C. area, where you talked about foreclosures. But in the D.C. area, the majority of those foreclosures were not FHA; they came from foreclosures from privately funded subprime loans that were not insured by FHA.

And I see Ms. Gordon is champing at the bit.

Ms. Gordon, do you want to add something?

Ms. GORDON. Yes, I just want to say, with all due respect, what Mr. Sanders and Mr. Pinto are doing is blaming the firemen for getting the house wet. FHA did not cause the crisis. FHA was virtually absent from the market when this got started.

FHA has come into neighborhoods, neighborhoods that have been in something of a death spiral with foreclosures and the like, and tried to put some kind of floor under that and allowed people in those neighborhoods, many of which are neighborhoods with large communities of color, to get their feet back under them.

Mr. MEEKS. In fact, even in Mr. Pinto's statement, I believe he said that FHA is overly concentrated in low- and moderate-income communities. But that is FHA's core mission, to help creditworthy low- and moderate-income families. That is what their core mission is.

I am going to yield back the balance of my time.

They are going to come back? Oh, great. Good. Then I can keep going.

Mr. Pinto, in your answers to Mr. Watt, I think that maybe you might want to—your statement clearly seems to me that you are not for the mission of FHA; you don't agree with it. Because you are saying in your statement that it was overly concentrated in low- and moderate-income communities, which is exactly what their mission is.

I think that you raised your hand and then you put it down, so I want to give you a chance to really state—and it is okay. If you are not for the mission of FHA, then state it. Because that seems to be what your testimony is.

Mr. PINTO. I appreciate that.

First, let me say that FHA was not the firemen, they were the arsonist. Starting in 1992, Congress ordered FHA, Fannie Mae, and Freddie Mac to go down an arms race of weakened lending practices that led to the problems that we had, along with the National Homeownership Strategy.

But on to your point, I am not against FHA's mission of serving working-class families and communities. What I am against is abusive lending practices by FHA in those communities and to those families. And that is what I have documented.

If you go to page 25 of my testimony, you will find an explicit way to serve those communities precisely in a way that is not abusive and does not finance failure, which is what FHA has done—

Mr. MEEKS. All those delinquencies that you say were in private industry—

Mr. PINTO. —for 30-plus years.

Mr. MEEKS. —so, therefore, the private industry that had all of those delinquent loans, that really caused—when they bundled them, sold them, they are not the arsonists. They should be exempt from what you have been talking about.

And I see Ms. Gordon is champing at the bit. I am going to give Ms. Gordon a chance to say something there.

Ms. GORDON. I think that it is insane to consider FHA abusive lending. This is fixed-rate, long-term, sustainable, underwritten mortgages. We know what toxic loan products look like, and they don't look like this.

UNC has recently done a very in-depth longitudinal study of a group of something like 46,000 lower-income, lower-FICO home buyers who were given these 30-year, fixed-rate mortgages, sometimes with lower downpayments than FHA requires. And those loans have outperformed all but the very—

Chairman HENSARLING. The time of the gentleman has expired.

I want to announce that the House is in recess at the moment, so several of you need not rush off.

The Chair now recognizes the gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

I think one of the questions that was asked is a good question, and that was, what does it take to get the private sector back into this market? I think a couple of things would help that process.

One is, if I was a private company and the Federal Government would subsidize my operating costs—that is what we do with FHA; they do not take any of their operating costs out of the fund revenue—and that I had an unlimited credit line at the United States Treasury and I didn't have to answer to any shareholders, I could be very competitive in making loans competing with FHA.

But the truth of the reality is, in the marketplace today, it is very inexpensive to sanitize these mortgages, either running them through FHA, Fannie Mae, or Freddie Mac. And so, you have 90 percent of the market being sanitized there for a very low risk premium. If you want the more private market to come back in, you have to level the playing field, and the playing field is not level. Comments, Mr. Pinto, Mr. Sanders, Mr. Petrou?

Mr. PINTO. Yes, absolutely. I think I testified 3 years ago that the housing policy in the United States has created a brick wall that the government mortgage complex has created. And that complex is impenetrable. It is 10 feet high, very wide, and it goes underground. So you can't dig under it, you can't go over it, and you can't go around it.

The private sector doesn't like to break through brick walls. They like to go into opportunities. As long as the private sector—as long as the government mortgage complex, which is Fannie, Freddie, the FHA, VA, Ginnie Mae, USDA, all of these entities, are out there with their different programs, it is very difficult for the private sector to compete.

The advantages that Ginnie Mae brings to FHA are not very well-understood. Ginnie Mae reduces the rate on FHA loans by a substantial amount. It actually almost offsets the amount of some of the premium increases that have taken place. And the result is that those securities sell at a higher price in the securities market than a Fannie Mae security. That is a subsidy, an implicit subsidy, that goes to FHA. And, again, it makes it very hard to compete.

That is why these higher-income loans—you ask, why are those loans being made? The reason they are being made is because of the Ginnie Mae subsidy. They charged a lot on the FHA side, but you then add in the Ginnie Mae subsidy and those loans are able to be done.

So the market is not a level playing field, and we need to get to one.

Mr. NEUGEBAUER. Mr. Petrou?

Mr. PETROU. I agree completely. Ginnie Mae is pricing right through Fannie/Freddie securities, and that is the key factor in terms of trying to "compete."

In the immortal words of Milton Friedman, we could still have a Pony Express, if you want to subsidize something like that, but we chose not to. And the reality is that nobody is going to get into this market as long as the government is blocking them with this cheap pricing.

Mr. NEUGEBAUER. And before you respond, Mr. Sanders, the other thing, too, that I didn't mention is this new risk that everybody is trying to figure out how to price, and that is called the regulatory risk now that falls onto the private mortgage market that doesn't necessarily fall to those loans being originated through FHA and Freddie and Fannie. Is that correct?

Mr. SANDERS. That is correct. Dodd-Frank and, to a large part, the Consumer Financial Protection Bureau omits Freddie and Fannie and FHA. So we have for the lenders a very stringent set of standards, including prime risk and the associated blame with that, but Fannie and Freddie and FHA just seem to have somehow waltzed their way out of this. So they are not really under the regulatory supervision of Dodd-Frank.

That has been pointed out before, but that has to be fixed. We have to have rules governing the FHA, Freddie, and Fannie that make it a level playing field with the banks, the lenders.

Mr. NEUGEBAUER. Yes. So we are really comparing apples and oranges when we try to compare. And we are going to have a hearing in our subcommittee, and we are going to dive deeper into this so that we can begin to contrast these entities from an accounting standpoint, from the regulatory standpoint, to try to build a model here so we can tell why these entities aren't able to compete.

I just had one last question for Ms. Gordon.

Ms. Gordon, you said that if the money is advanced to FHA, it isn't a bailout because it isn't the taxpayers' money, it just comes from the Treasury. Do you know where the Treasury gets its money?

Ms. GORDON. No, we have discussed that already. That is not what I said. What I said is Congress does not have to vote on some kind of bailout.

Mr. NEUGEBAUER. No—

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Massachusetts, Mr. Capuano.

Mr. CAPUANO. Thank you, Mr. Chairman.

I want to thank the panel for being here today. As I said, I think you raised a lot of good questions. But I want to make a few points.

First of all, we haven't publicly stated, though I know it is in your testimony, that at this very moment FHA has $30.4 billion worth of cash ready and available to cover it. I understand that over the long term they have some concerns; I am not even arguing the point. That is why I want to hear some of the things. But this is not a crisis that is going to happen tomorrow, at least not right away tomorrow.

I also want to be clear that the FHA has taken—I have a list of 15 different steps that they have taken over the last several years to address these very issues you mention.

And I would like to submit that list for the record, Mr. Chairman, if I could.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. CAPUANO. Thank you.

But, this list includes increasing the mortgage premium rate at least 4 times. It might be 5 times; maybe I counted wrong. I am not even sure I like that, but at least it addresses your end of it.

They increased some of the downpayment requirements for different FICO scores. They changed some of the things for seller concessions. At least that is pending, as I understand it. The new debt-to-income ratios—they have done a whole bunch of the things, at least in general, that you have suggested. And they are in the middle of doing others.

Now, I am not suggesting they can't or shouldn't do more. But I think that needs to be recognized, as well, and that their book has gotten better over the last 2 years. I think those things have to be recognized. So I just want to put those on the record.

I also want to state very clearly that if the chairman or anybody else wants to put the bill out that this committee put out last cycle, we should do it today, get it on the Floor, get it through. We can beat up the Senate for the next 2 years, instead of waiting until we beat up everybody we want to beat up to put out a bill. Let's put the bill out that this committee voted last cycle. Let's put it out today so that we can get moving on some of the things that the FHA says it needs legislatively that I think everybody agrees we want to give them the power to do. So let's do that instead of just beating each other up.

I guess I want to also comment on some of the things that were said earlier.

Prudent lending. Who is against prudent lending? Now, the question is, define "prudence." Some people would define prudence as only lending to Donald Trump. That is prudent. He can pay it back. That means there is no middle class. The question on prudence is always about the ability to pay.

And, Mr. Petrou, I want to get to some of your comments. Because the reason is, all of these agencies deal with the amount of money that is available for loans, and it doesn't take into consideration regional differences. The cost of housing in my district is approximately 2 to 3 times the cost of housing in the chairman's district, but wages are approximately 70 to 100 percent higher, as well.

Mr. CAPUANO. The question shouldn't be on how much the house cost; it should be on whether the borrower can afford to pay. That all plays on all different things: downpayment requirements. I could not afford to buy any home in any district if you have a 50 percent downpayment requirement. What should it be? Should it be 5? Should it be 10? Fair questions. But to simply throw numbers out really begs further questions.

For me, those numbers are fine. FICO scores up, down, over. The question is, what does it mean to the middle class? Can FHA actually accomplish its mission based on some of these numbers? And the truth is none of these testimonies gives answer to that. They raise questions, but they don't give answers. I need to see answers as to what the impact is of some of the things you are suggesting.

And if we get to there, I don't think we are going to find ourselves on significantly different pages at the end of the day. Maybe we will, but right now we don't have it. If you have those statistics, I would like to get them.

I read your full testimonies, including your multi-page thing, and I didn't see them. I saw nice, generic comments and studies of what happened in poor neighborhoods. FHA belongs in middle-class and lower-income neighborhoods. We all agree with that. Was it the FHA or wasn't it? What is the impact to this?

Even by shifting to some of the things—for instance, the VA coverage of 50 percent versus 100 percent. Conceptually, I like that proposal. I don't know if 50 percent is the right number, I don't know the number, but the concept of somebody having skin in the game is a good concept. But I need to know, what does that do to rates? If you say we are going to have a 10 percent skin in the game, does that mean that my mortgage rate goes up 20 percent? And if it does, that means you are kicking out a whole lot of people from being able to do it.

So, for me, I guess I am asking especially those of you who have been enjoying kicking the recent history of FHA—I hope you are having a good time; that is great. It doesn't help me move forward. It doesn't help us get back to that mission.

So, for me, I need you to tell me: What are the impacts on these rates? Who are we kicking out of the housing market? And how is it going to impact some of these middle-class neighborhoods that we claim that we all want to help?

Mr. PINTO. Page 22 to 25 in my testimony explicitly and precisely answers every question you just asked.

Mr. CAPUANO. Actually, I did read it. I don't think it did, but we will talk about that another time.

Mr. PINTO. I would be happy to meet with you over it.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Campbell, for 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

What I would like to focus on in this 5 minutes is what FHA should look like going forward. Let's assume that we are developing a sustainable housing finance market, which means we have to do a lot of things around FHA, granted. Okay, that is going to be a lot of the work of this committee coming this year. But assuming that happens—and we will all be deciding at some point what that looks like—what, ideally, would we like FHA to look like?

Two things I would like to focus on, and that is, one, in terms of the original mission. I am from Orange County, California, a very high-cost area. FHA is doing a ton of loans from $400,000 to $700,000 in my area. A lot of low-downpayment loans, where people actually have more money for a downpayment but because loans are so cheap, interest rates are so cheap, they put as little down as they can—all kinds of things that it strikes me are not anywhere near—and I take your point, Ms. Gordon, about how we have softened what would have otherwise been a worse market. But that clearly is not what the original mission of FHA was.

I heard from you, Mr. Pinto, and you, Dr. Sanders, I think, about the original mission. I would like to hear from the other two of you, Mr. Petrou and Ms. Gordon, about what sorts of loans should FHA be making in this ideal sustainable market in the future.

Mr. PETROU. I think, as I say in my testimony, they should be targeted to the income of the borrower, not the loan amount. And that would be by geographic area on median income. And, consequently, if your borrowers in your district are of a certain income and they qualify for the loan, then those are the loans that should be made. You shouldn't have builders building up to an $800,000 limit because they are able to get it from FHA even though the median income in the area isn't at that level.

And it also addresses the fact that when interest rates go up, the amount of money that qualifies falls for these mortgages. And you have to take that into consideration, as well.

Mr. CAMPBELL. Okay.

Mr. PETROU. And, finally, on downpayment, it is critical that the downpayment be reflective of the risk.

Mr. CAMPBELL. I am going to get to that.

Ms. Gordon?

Ms. GORDON. Mr. Pinto referred to Gale Cincotta before, and I think I am fighting for the same thing she was fighting for, which is just to make sure that credit is available in all the communities of this country and to people of low wealth, people of color, younger people.

And so, in my ideal world, you see both Fannie and Freddie and the private market competing for that business. I would far prefer to see most creditworthy borrowers served by a private market, maybe with some kind of government backstop, so that government is not on the hook for the first loss, and see FHA fill in behind that for people who otherwise need some assistance. I actually think we all share that vision. We may have slightly different views of how to get to it.

And I am not sure how you pull FHA back before you make sure there is something coming in behind it so we don't go into another round of home price declines.

Mr. CAMPBELL. Right. And I get that. But, and to your point, I think there is agreement on the panel that we would like to see FHA go back to what it was originally designed to do. And as much as I get it and it is my district and all that now, they shouldn't be making $700,000 loans on million-dollar houses. There should be other accommodations for that sort of loan.

Let's talk about whether FHA insures from dollar 1. With a 3½ percent downpayment, effectively, when you sell a house, that doesn't cover the commission. So, essentially, FHA insurance covering from dollar 1 of the potential loss.

I would like to start with you again, Ms. Gordon, and then work back the other way and just see, do you think that FHA should be doing that? Or should someone else bear some of the risk, 5 percent, whatever?

Ms. GORDON. For the role that FHA would ultimately play, this is part of the historical mission, that FHA is an insurance program which is backed by the U.S. Government. And I think that is an appropriate role. But I think that what is important is that we make sure there are ample opportunities and avenues, channels for credit elsewhere that do not have—

Mr. CAMPBELL. Okay. Let me give someone else the final 14 seconds.

Yes?

Mr. PETROU. I would recommend that you could do a risk-share program within FHA so you could have a private risk at the first dollar loss, FHA takes the remainder down to 30 percent, and then the lender is on the hook for anything deeper.

Chairman HENSARLING. The time of the gentleman has expired.

We will call upon two more Members and then adjourn.

Mr. Green from Texas is recognized for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank you and the ranking member for the dinner that we had together to engender a degree of civility and friendship. And I want to assure the people who are watching at home that we really did have the dinner.

Let me start by saying to you that I did not come prepared to defend FHA today, but I feel compelled to do so. FHA did not create the housing crisis. Some things bear repeating. FHA did not—N–O–T—create the housing crisis.

It started in the 1980s with these so-called exotic products. And I am sure you remember some of them, but for fear that some do not, let me express to you what some of them were.

Teaser rates that coincided with prepayment penalties. FHA didn't creates teaser rates that coincide with prepayment penalties, such that you are locked into a loan and you can't get out unless you pay some large amount of money.

Qualifying buyers for teaser rates but not qualifying buyers for the adjusted rate. FHA didn't create that product. By the way, Dodd-Frank addresses these products.

Balloon mortgages. One big payment at the end of some period of time, after having maybe an interest-only payment.

Option ARMs. Underpay, and we will tack what you don't pay onto the principal.

No-doc loans.

Rating agencies that—at least one of which is now being prosecuted—rating agencies that were literally giving those who desired an evaluation what they wanted.

Credit default swaps in the tertiary market so that you could kind of gamble together with the taxpayers' money, in a sense.

Originators of loans not having to be responsible for the default. Probably more than anything else, this was the gravamen of the problem. When we allow the originator to care less about whether or not there would be a default, just qualify the person as a home buyer rather than a homeowner, and send that on to the secondary and tertiary market, somebody else will worry about the default, this is what it was all about.

Let's not kid ourselves and try to blame the CRA and FHA for what happened in the—started in the 1980s and ended up with the crisis that we had to give some attention to.

FHA does insure—does not lend a penny, by the way—some loans that some would consider high-dollar loans. But would it surprise you to know that in October, the average loan amount for FHA was around $180,000, $183,000, less than $200,000? Would it surprise you to know that the entire portfolio of FHA has loans that average around $150,000? FHA is not a culprit.

So let me just ask one question, and I will probably then yield some time so that others can be heard. But my one question is to the entire panel.

Who among you would end FHA—would end it rather than mend it? Which of you would end it? I ask that you acknowledge that you would, if this is your position, by kindly raising your hand. Kindly raise your hand.

Now, Mr. Pinto, I don't see your hand going up, so I am going to assume that you would not end FHA. This will require, unfortunately, because time is of the essence, a yes-or-no answer. And perhaps we will get into—

Mr. PINTO. I can't—I answered the question earlier not yes-or-no. I am sorry, it is just not a yes-or-no question.

Mr. GREEN. Not a yes-or-no. Then I will conclude, if I may—and you can have someone else help you with this, if you would like—but I am going to conclude that under certain circumstances, you would. And that is all I can conclude.

Is there anyone else who would end the FHA?

All right. Let me close with this, dear friends. I came to Congress to represent everybody in this country. And in so doing, I understand that there are a good many people who cannot go back to the 1930s, when you had 3- to 5-year loans, when you had huge balloon payments, when the interest rates were exceedingly high.

FHA has provided middle-income persons with an opportunity to engage in homeownership. We have to mend it. There may be some problems. But we didn't end the big banks. We gave them a second life. I am going to fight to keep FHA.

Chairman HENSARLING. The time of the gentleman has expired.

And I would just let the gentleman know, having paid for half of the bipartisan dinner, I certainly recall it.

The Chair now recognizes the gentleman from Georgia, Mr. Westmoreland.

Mr. WESTMORELAND. Thank you, Mr. Chairman.

To my colleague from Texas, FHA does not have to meet the same QM/QRM standards that the Dodd-Frank requires private companies to have.

And, Ms. Gordon, I just want to clarify one thing. I think the gentlelady from California was talking to you about the minus 1.44, and you were explaining that this does not have to do with the $30 billion that they have in the bank but that this was something that, if all of them come due at one time, that the fund would be a little bit short.

Just for clarification so I can kind of get the perspective on it, what is a "little bit short?"

Ms. GORDON. The point I was making is that right now FHA has cash on hand, as has been pointed out by several of the Members today, and that the measurement that we are talking about is a measure of if FHA stopped doing business today and paid out its claims, not all at once but over the next 30 years.

Mr. WESTMORELAND. Yes. But what is a "little bit?" Because my numbers say it would be $16 billion.

Ms. GORDON. We don't actually know what the number is because this is not the same number as will correspond to—

Mr. WESTMORELAND. All right. What would your "little bit" be?

Ms. GORDON. I think what I am trying to look at is what the value is that we are getting for our money here.

Mr. WESTMORELAND. Okay. I don't think you are going to answer the question, or maybe I am not asking it correctly.

In President Obama's Fiscal Year 2013 budget, FHA requested about $688 million to cover the expected losses during this fiscal year. Ultimately, FHA did receive $1 billion from the DOJ settlement with the banks and averted a taxpayer, what I would term a "bailout."

And given what you all know about FHA's current financial situation, could each one of you give me an estimate on how much money you think that the FHA will need to cover their losses in Fiscal Year 2014?

Mr. PINTO. I think the number is going to be in the negative $10 billion to $12 billion range.

Mr. WESTMORELAND. Twelve billion?

Mr. PINTO. Yes, $10 billion to $12 billion, negative.

Mr. SANDERS. That is a reasonable estimate, but, again, it all depends on whether we ever actually get out of this super-slow-economic-growth thing or do we have a double dip in the economy, which is possible. Then all bets are off.

Mr. WESTMORELAND. Right.

Mr. PETROU. FHA has a lot of real estate owned on its books right now, and a lot of how much loss is buried in that real estate owned. So while I think $10 billion to $12 billion makes sense, it could go a lot higher.

Ms. GORDON. I am not the economist as some other people may be, so I can't give you a number. But I can say it will depend a lot on the housing market, and it will depend on how well we continue to engage in loss mitigation, which is an area where I think the FHA still has significant room for improvement.

And some of the efforts they are making in terms of the distressed asset sales and some of the changes they have made to the REO process, all of those things work together to determine how much money will be lost ultimately.

Mr. WESTMORELAND. There are approximately, I think, six private mortgage insurance companies that write private mortgage insurance. And if I understand it correctly, they are under regulations by their States as to a capital requirement or whatever you want to say, as far as being able to cover their losses.

And I would like to ask each one of you, how do you think they would rate the FHA as compared to some of the private mortgage insurance companies in their financial situation?

Mr. PINTO. If you took away FHA's government guarantee and its access to the Treasury, FHA would be closed down, I believe, by every State regulator in the country because they have no capital today, period.

What is called this $30 billion in the bank, for a private mortgage insurer you would go through the roughly 700,000 delinquent loans, 60 days or more, you would figure out how much money you would expect on just those loans you know about, and that exhausts the $30 billion, plus. And so, they have no money on a regulatory basis under private mortgage insurance or under a GAAP accounting basis.

Chairman HENSARLING. Regrettably, the time of the gentlemen has expired.

Votes are being held open. I would like to recognize the ranking member for a UC request.

Ms. WATERS. Mr. Chairman, I ask unanimous consent that the following materials from organizations that support the Federal Housing Administration be entered into the record: a statement from the National Association of Home Builders; a publication by the National Association of REALTORS®; a statement from the National Council of La Raza; a statement from the Local Initiatives Support Corporation; and a statement from Brian Chappelle, a partner with Potomac Partners, which specializes in mortgage finance.

Chairman HENSARLING. Without objection, it is so ordered.

I would like to thank each of our witnesses for coming to testify today.

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 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

The Chair announces that the next full committee hearing will take place Wednesday, February 13th, at 10 a.m., with FHA Commissioner Carol Galante.

Without objection, this hearing is now adjourned.

[Whereupon, at 11:20 a.m., the hearing was adjourned.]

A P P E N D I X

February 6, 2013

Statement
of
Representative Gwen Moore
Hearing
Examining the Proper Role of the FHA in Our Mortgage Insurance Market

February 6, 2013

Chairman and Ranking Member, it is a pleasure to be back. I look forward to continuing to work with you both in the 113^{th} Congress.

I would also like to welcome the new members to the committee. It is a diverse and talented group on both sides that I am excited to work with.

I am pleased that the committee will begin with a hearing on housing.

There are a variety of opinions on this committee on how to address various housing issues. I am interested to see how those views play out and, hopefully, lead to meaningful reforms that strengthen the housing sector and fulfill FHA's important mission.

I endeavor to keep an open mind as we look at these issues and to work with anyone that wants to find a reasonable path forward.

I truly believe the comity that exists on this committee enables us to have tough debates that get us to good results.

One area that I will be following as this debate evolves is the role of the FHA single family mortgage insurance program and avenues to bring back the private mortgage insurance sector. I really look forward to working with the Chairman and Ranking Member to explore way for the private sector mortgage insurers to provide more affordable and responsible housing finance options.

Finally, I would like to call attention to the fact that the President has made half a dozen good FHA reforms already. I trust that we can find a way forward to supplement and finish the Administration's work.

We have a lot of leadership on this issue, including Ranking Members Waters, who has been wonderful on housing issues.

I look forward to hearing from the witnesses and kicking off the 113 Congress.

Thank you.

Statement of Randy Neugebauer
Full Committee Hearing
"FHA: Examining its Proper Role in our Mortgage Insurance Market"
February 6, 2013

Thank you, Mr. Chairman, for holding this important hearing examining FHA's role in the mortgage insurance market. As you mentioned, this is the first in a series of hearings. I look forward to holding similar hearings in my Subcommittee. I also look forward to working with you, Ranking Member Waters and Ranking Member Capuano as we seek to reform FHA and nurse it back to financial health.

As we meet today, FHA's financial condition continues to deteriorate. FHA's most recent actuarial report showed that it's MMI Fund capital reserve ratio fell to *negative* 1.44 percent – well below the Congressional mandated ratio of 2 percent. This means that FHA does not have sufficient reserves to cover its expected losses. The report also noted that the MMI Fund's economic value was *negative* $16.3 billion, paving the way for another taxpayer funded bailout. This is on top of the roughly $190 billion taxpayer bailout of the GSEs.

As if the impending bailout were not enough, I am becoming increasingly concerned as FHA strays far away from its intended mission. FHA was created in the 1930's with a unique mission to serve targeted populations such as first-time homebuyers, communities with little access to credit, and other higher-risk borrowers who were still creditworthy. But this isn't your grandparents' FHA. In fact, over 90 percent of FHA loans insured today would not have even qualified for insurance under the original program.

Since the onset of the financial crisis, the Agency has morphed from a mortgage insurer of last resort to a dominant component of our mortgage finance system. It has done this by expanding its insurance to higher income borrowers and houses in the upper end of the marketplace. For example, in my hometown of Lubbock, TX the area median home price is roughly $132,000; however FHA can insure loans up to $271,050 – more than double the median home price.

As a result, FHA's insurance portfolio has exploded to $1.12 trillion – making it equivalent in size to the entire property & casualty and life & health insurance industries combined. Not surprisingly, FHA's unwieldy growth has crowded out private mortgage insurers, thereby thwarting the ability of private capital to enter the mortgage market. According to the GAO, FHA's share of the mortgage insurance market stands at 56% compared to just 19% for the private insurers. And given FHA's dire financial condition, it is unlikely that its market share or its insurance portfolio will be reduced as the Agency attempts to grow its way out of its problems.

Finally, it is worth noting that FHA's insatiable desire to "grow out of the problem" has led to an aggressive push that could have devastating consequences for the very people FHA is intended to help. FHA's expanded role has been fueled by similar tactics employed by subprime lenders at the height of the housing boom. While appropriate for some, these practices – including seller concessions, small down payments, low credit scores, and cheap upfront pricing – can entice others who are unprepared for the obligations of homeownership to overextend themselves. The likelihood of enticing such borrowers is heightened as FHA becomes more aggressive in its push to ramp up its market share.

I thank the Chairman for calling this hearing and I look forward to hearing from our witnesses today as we address these important issues.

Opening Statement of Rep. Ann Wagner (MO-2)
Full Committee
House Committee on Financial Services
"Examining the Proper Role of the Federal Housing Administration in our Mortgage Insurance Market"
February 6th, 2013

I would like to thank Chairman Hensarling for holding this important series of hearings on the critical situation at FHA.

Nearly four and a half years after taxpayers were forced to commence what has become a nearly $200 billion dollar bailout of Fannie Mae and Freddie Mac, it appears that the worst-kept secret in Washington is now official: The FHA is broke, and taxpayers are on the verge of bailing out yet another federal housing agency.

With over $1 trillion in taxpayer liabilities and an alarming default rate of nearly 10%, the FHA has caused pain for the very homeowners it is meant to serve, and is likely about to cause even more pain for the American taxpayer. It's time to end the bailouts of failed policies and put our housing market back on sound footing with private capital playing its proper role. I look forward to taking the first step today towards bringing real and lasting reform to our housing market.

Center for American Progress Action Fund

Julia Gordon
Director, Housing Finance and Policy,
Center for American Progress Action Fund

before

The Committee on Financial Services
United States House of Representatives

"Examining the Proper Role of the Federal Housing Administration in our Mortgage Insurance Market"

February 6, 2013

Good morning Chairman Hensarling, Ranking Member Waters, and members of the committee. Thank you for the opportunity to testify today about the role of the Federal Housing Administration in our mortgage insurance market.

The Federal Housing Administration is a government-run mortgage insurer. It doesn't actually lend money to homebuyers but instead insures the loans made by private lenders, as long as the loan does not exceed a certain size and meets strict underwriting standards. In exchange for this protection, the agency charges up-front and annual fees, the cost of which is passed on to borrowers.

The FHA was established in 1934 to help promote long-term stability in the U.S. housing market. Emerging from the foreclosure crisis that occurred during the Great Depression, FHA transformed housing finance by demonstrating how long-term, fixed-rate mortgages can help middle-class families build long-term economic security even through uncertain economic times. FHA was integral in transforming the standard mortgage from a 50 percent LTV, short-duration loan that required frequent refinancing to a 20 percent down, long-term, fixed-rate mortgage.

In the almost 80 years since, FHA has helped more than 40 million creditworthy families realize the benefits of homeownership, and has developed a niche of providing low-down-payment loans through its single-family programs to creditworthy, lower- wealth, and otherwise underserved borrowers.

Under normal economic conditions, the agency typically focuses on borrowers that require low down-payment loans—namely first-time homebuyers and low- and middle-income families. During market downturns, when private investors retract, and it's hard to secure a mortgage, lenders often turn to Federal Housing Administration insurance to keep mortgage credit flowing, and the agency's business tends to increase. This so-called countercyclical support is critical to promoting stability in the U.S. housing market.

During the recent financial crisis, lenders turned to FHA as private investors retreated from the mortgage business in the wake of the worst housing crisis since the Great Depression and as Fannie Mae and Freddie Mac entered conservatorship. Fortunately, FHA was able to help keep mortgage credit available. Without the agency's support in recent years, it would have been much more difficult for middle-class families to access mortgage credit and the housing recovery would be much further away.

Perhaps even more important, the agency's actions prevented home construction from plummeting 60 percent from already depressed levels and home prices from dropping an additional 25 percent. This would have sent our economy into a double-dip recession, costing 3 million jobs and half a trillion dollars in economic output.[1]

It is important to note that as a government agency, FHA's mission is not to maximize profits, but to provide important capacity in the housing market that may ebb and flow depending on macroeconomic conditions. Some books of business yield a positive economic value, while others have a negative value. In simple terms, FHA's long-term financial health depends on building a strong capital cushion from well-performing books so that it can continue to reach underserved borrowers and to do business in stressful periods when other credit providers withdraw.

Critics claim that FHA's basic business model is flawed. For evidence, they point to a concentration of lending in areas where default rates are high. This criticism is essentially blaming the fireman for getting the house wet. Risky subprime lending dominated the market in these neighborhoods, with FHA largely standing on the sidelines. As those toxic loans failed, FHA lending was available to keep housing market activity alive. Loans made under these circumstances naturally have higher loss rates, but as described above, if lenders and borrowers had not had access to FHA when other credit dried up, it is likely these neighborhoods would have been lost permanently.

A. FHA Today: Fulfilling its Mission of Providing Access and Countercyclical Capacity

In the late 1990s and early 2000s, the mortgage market changed dramatically. New subprime mortgage products emerged, bundled by private Wall Street investment firms into mortgage-backed securities. These designed-to-fail products featured loan terms such as steep rate resets, prepayment penalties, and negative amortization. Underwriting ranged from poor to nonexistent.[2]

Yet, these loans required less paperwork and tended to offer far better compensation for their originators than FHA-backed loans, in part due to creditor bonuses to brokers for steering borrowers into riskier and more expensive loans than they qualified for.[3] As a result, many borrowers who would have qualified for FHA loans ended up in the dangerous subprime loans instead.[4]

As private subprime lending took over the market for low down-payment borrowers in the mid-2000s, the agency saw its market share plummet. In 2001 the Federal Housing Administration insured 14 percent of home-purchase loans; by 2006 that number had decreased to less than 4 percent.[5]

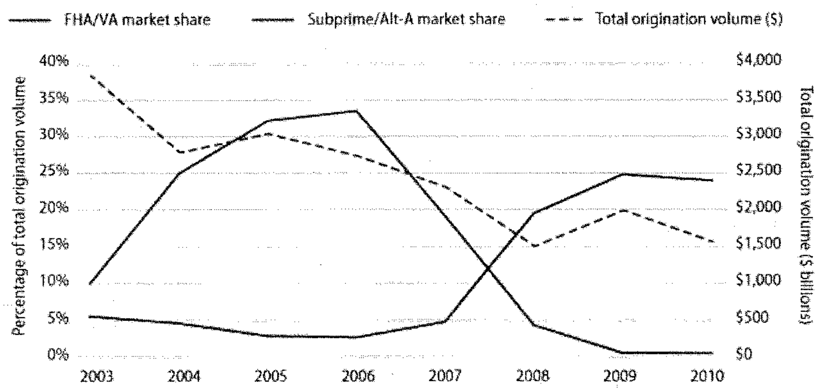
All this easy subprime money fueled a steep increase in home prices. The bubble burst in a flood of foreclosures, leading to a near collapse of the housing market. Wall Street firms stopped providing capital, banks and thrifts pulled back, and subprime lending essentially came to a halt. The mortgage giants Fannie Mae and Freddie Mac also faced such large losses that the government placed them under conservatorship. As a result, they significantly scaled back lending, especially for home-purchase loans with low down payments.

True to its role to provide countercyclical liquidity, lenders and borrowers turned to FHA to fill the gap. By 2009 the agency had taken on its biggest book of business ever,[6] backing roughly one-third of all home-purchase loans.[7] Since then the agency has insured a historically large percentage of the mortgage market, and in 2011 backed roughly 40 percent of all home-purchase loans in the United States.[8]

FIGURE 1

As private investors left the mortgage market, FHA insurance filled the gap

Share of annual origination volume (home purchases and refinancings), 2003–2010



Source: Center for Responsible Lending (citing data from Inside Mortgage Finance) and the Mortgage Bankers Association

Looking at the borrowers served as part of this massive increase in volume demonstrates the unique role of FHA in the housing finance world. In 2012, 78 percent of FHA endorsements were for first-time homebuyers.[9] According to the National Association of Realtors, FHA provided financing for 46 percent of first-time homebuyers that year, while the conventional market financed 33 percent of them.[10] These first-time homebuyers are important to the housing recovery, especially as existing homebuyers remain on the sidelines. In 2011, FHA also financed half of the home purchase mortgages obtained by African Americans and Latino homebuyers.[11] Moreover, in 2012 over 60 percent of FHA's endorsements[12] were for home purchase loans whereas only 28 percent of Fannie Mae and Freddie Mac originations were for home purchase loans.[13]

B. <u>Without the Federal Housing Administration, the Housing Downturn Would Have Been Much Worse.</u>

Since 2008, the agency has backed more than 3 million home-purchase loans and helped another 2.7 million families lower their monthly payments by refinancing.[14] Without the agency's insurance, millions of homeowners might not have been able to access mortgage credit since the housing crisis began, which would have sent devastating ripples throughout the economy.

While it's difficult to know precisely what would have happened to the economy but for the liquidity provided by FHA, Moody's Analytics addressed this issue in the fall of 2010. According to preliminary estimates using their models, if the Federal Housing Administration had simply stopped doing business in October 2010, by the end of 2011, mortgage interest rates would have more than doubled. New housing construction would have plunged by more than 60 percent; new and existing home sales would have dropped by more than a third; and home prices would have fallen another 25 percent below the already low numbers seen at this point in the crisis.[15]

The analysis goes on to suggest that a second collapse in the housing market would have sent the U.S. economy into a double-dip recession. Had FHA closed its doors in October 2010, by the end of 2011, gross domestic product would have declined by nearly 2 percent; the economy would have shed another 3 million jobs; and the unemployment rate would have increased to almost 12 percent. We can only imagine what this additional damage would have meant for losses and taxpayer costs at the GSE's and other financial institutions.

TABLE 1

Without the Federal Housing Administration, the housing market would have collapsed in 2011, sending the U.S. economy into a double-dip recession

Projected year-to-year changes in key economic indicators had the agency stopped insuring mortgages in October 2010

Indicator	Percent change
U.S. housing market	
Fixed Mortgage Rate	+6.7 percentage points
Residential Housing Starts	-63.0%
New and Existing Home Sales	-40.5%
Median Existing-House Price	-25.0%
Broader economy	
Total Employment	-2.7%
Unemployment Rate	+1.6 percentage points
Gross Domestic Product	-3.7%
S&P 500	-39.2%

Source: Draft estimates from Moody's Analytics, October 2010

According to Mark Zandi, chief economist for Moody's Analytics, "[The administration] empowered the Federal Housing Administration to ensure that households could find mortgages at low interest rates even during the worst phase of the financial panic. Without such credit, the housing market would have completely shut down, taking the economy with it."[16]

C. Current Financial Condition: The Crisis has Taken a Toll

The breadth and depth of the 2008 financial collapse and FHA's shock absorption role exposed the FHA to significant risk. As a result, FHA today faces mounting losses on loans originated as part of its countercyclical role.

According to data from the FHA actuarial report, in fiscal year 2012 the capital reserve ratio of the agency's primary insurance fund fell below zero to negative 1.44 percent, and the Fund's economic value stands at negative $16.3 billion.[17] (The "capital reserve ratio" is a measure devised by Congress in 1990 to improve oversight of FHA and to safeguard the MMI Fund in the case of economic hardship. If the ratio is below two percent, the agency is required to present Congress with a plan to restore the capital reserves.[18] The "economic value" refers to the amount that would be needed for FHA to meet all its expected claims over the next 30 years if FHA closed its doors tomorrow and had no new business to offset those claims.)

It is important to put FHA's current capital ratio challenges in context. Immediately prior to the financial crisis in 2007, FHA's capital ratio was 6.4 percent – more than triple the required level.[19] This buffer, designed to support FHA through difficult economic times, served its purpose and allowed FHA to respond to the 2008 financial collapse and subsequent economic downturn without the assistance sought by some over-leveraged private firms.[20]

As dire as these numbers sound, the fact is that the Federal Housing Administration is not running out of cash anytime soon. The agency still has $30.4 billion in its coffers to settle insurance claims as they come in, estimating that it has enough cash for at least 7-10 years.[21] However, under federal budgeting rules, if FHA does not have enough in its capital account to cover the 30 years' worth of claims, it must draw from an account at the Treasury Department to fill the gap. We will not know for certain until September whether that draw will occur.

If FHA does require a draw, it is important to understand what such a move does and does not mean. Most important, it does *not* mean a congressional bailout. Since its creation in the 1930s, the agency has been backed by the full faith and credit of the U.S. government, meaning it has full authority to tap into a standing line of credit with the U.S. Treasury in times of extreme economic duress—with no act of Congress necessary.[22] (Note that if the capital fund does need to be replenished, no money actually leaves the Treasury; it is simply moved from one account to another.)

In addition, mortgages insured by the Federal Housing Administration in more recent years are likely to be some of its most profitable ever, generating surpluses as these loans mature. The actuary projects that the MMI Fund capital reserve ratio will be positive by FY 2014 and reach 2.0 percent during FY 2017 under its base-case estimate. These forecasts assume no changes in policy or other actions by FHA, so the package of changes recently announced[23] will likely accelerate the time to recovery.

Today is not the first time FHA has faced a negative economic value. Most recently it faced a negative economic value in 1990 but by 1997 was capitalized at three times the required levels.[24] Frankly, what is remarkable is not that FHA is facing hard times but rather that it continued operating without assistance in the midst of the greatest housing catastrophe in generations.

Notably, one should carefully dissect calls to make FHA function "like the private sector." The private mortgage insurance industry has been significantly weakened by the crisis,[25] with some private mortgage insurers seeking bankruptcy or being taken over by regulators.[26] Moreover, FHA has a different mission, much of which acts as a complement to the private sector.

D. FHA Losses are Due to Post-Crisis Business and Seller-Funded Down-Payment Programs, Not Normal Insurance Activity.

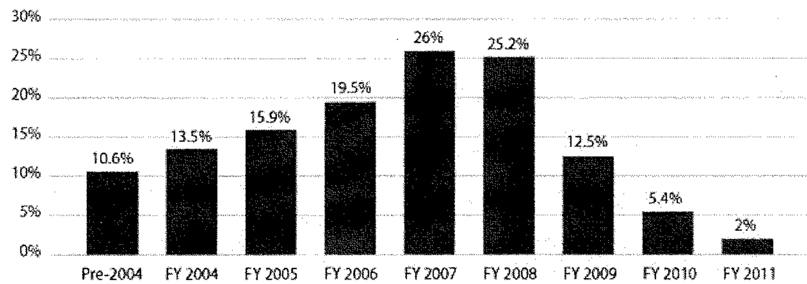
To understand whether the current condition of the agency's mortgage insurance fund is due to the recent crisis or to a fundamental problem with its model, consider where the current losses are coming from. The agency is currently facing massive losses on loans insured in the later years of the housing bubble and the early years of the financial crisis, when lenders started turning to the agency after other sources of credit dried up. These losses are the result of a higher-than-expected number of insurance claims, resulting from unprecedented levels of foreclosure during the crisis.

According to recent estimates from the FHA's recent actuarial report, loans originated between 2005 and 2009 are expected to result in $30 billion in losses for the Federal Housing Administration.[27] The 2008 book of business – the year that the crisis culminated – accounts for about $13 billion of those losses, making it the worst book in the agency's history by just about any metric. [28]

FIGURE 2

A high percentage of FHA-insured loans originated in 2006, 2007, and 2008 are expected to go to claim in the near future

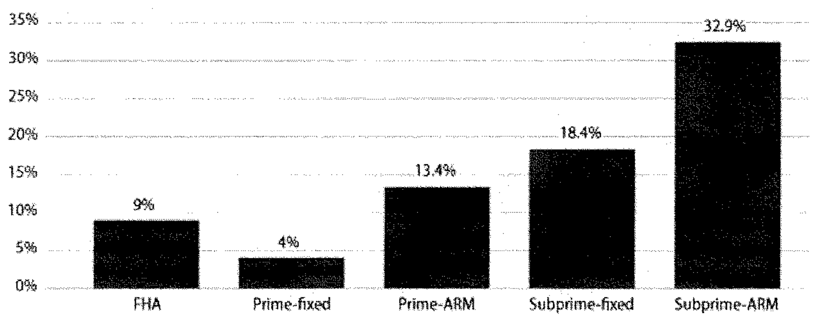
Percentage of FHA-backed mortgages that have missed at least three consecutive payments or are in bankruptcy/foreclosure processing



Source: Federal Housing Administration's Delinquency and Claim Rate Activity and Trends Report, July 2012

But as a whole, FHA's delinquency rates are much lower than riskier mortgage products

Percentage of mortgages that have missed at least three consecutive payments or are in bankrupcy/ foreclosure processing by type of loan



Source: Mortgage Bankers Association National Delinquency Survey, First Quarter of 2012

One of the reasons for the outsize losses from those years is that these books of business have a high concentration of loans under a special program to provide seller-funded down-payment assistance. This particular brand of seller-funded loans was often riddled with fraud and defaulted at a much higher rate than traditional FHA-insured loans. These loans made up about

19 percent of the total origination volume between 2001 and 2008, but account for 41 percent of the agency's accrued losses on those books of business.[29]

FHA unsuccessfully had tried to eliminate this seller-funded down-payment-assistance program from its programs, but it was not until 2008 that Congress finally banned it in the Housing and Economic Recovery Act (which didn't take effect until the second fiscal quarter of 2009). If such a ban had been in place from the start, the agency could have avoided more than $15 billion in losses, which would have put it in a much better capital position going into the crisis, according to the latest actuarial report.[30]

Yet while the losses from loans originated between 2005 and 2009 will likely continue to appear on the agency's books for several years, the Federal Housing Administration's more recent books of business are expected to be very profitable.

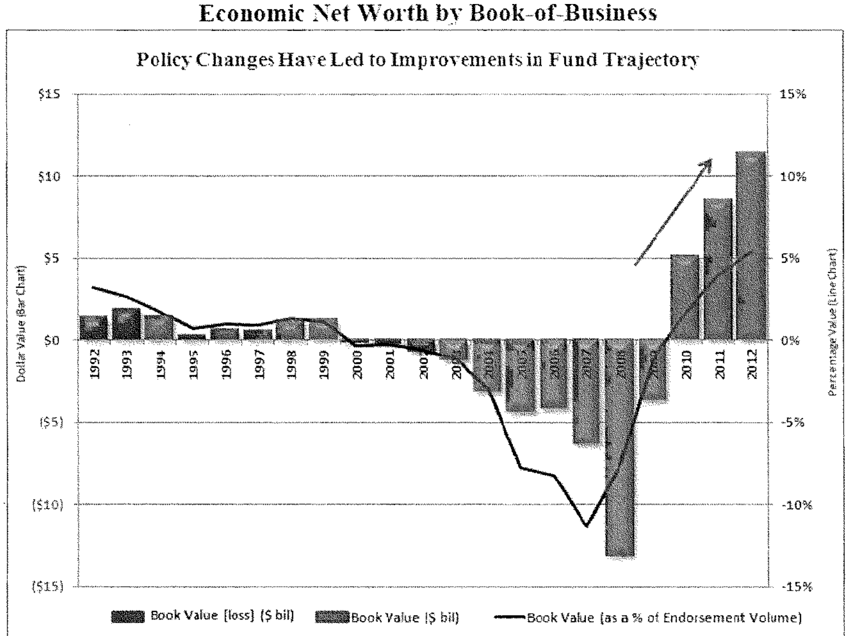
Some of the improvement going forward will result from the dramatic decline in loan delinquencies and defaults. The single-family portfolio's ninety-day delinquency rate, often the first indication of strength or weakness of new insurance commitments, was approximately 0.3 percent in early 2012[31]. As a comparison, that so-called "early-period" delinquency rate was more than eight times higher at the peak of the foreclosure crisis in 2007.[32]

The portfolio's "serious" delinquency rate, which tracks delinquencies after 90 days, has also declined over the past two years, from 9.44 percent in early 2010 to 8.54 percent in the third quarter of 2012.[33] And the quality of FHA's loan portfolio seems to have improved since the crisis: serious delinquency rates for the 2009-2011 books of business are substantially lower rates than the 2006-2008 books.[34]

Improvements are also due to changes that FHA has already implemented to reduce risk, such as eliminating seller-funded down-payments, improving monitoring and oversight of lenders (which has improved compliance and resulted in the termination of bad lenders), and increasing down payment requirements for borrowers with credit scores below 580.[35] FHA also has begun a more aggressive program to sell distressed assets in bulk, and has improved its REO disposition processes generally.[36] The agency also now requires FHA-approved lenders to have a net worth of at least $1 million. Last but certainly not least, FHA has now increased mortgage insurance premiums five times since 2009.

Since the actuarial report was released, FHA has announced several other significant changes that will strengthen its finances going forward.[37] These include yet another increase in the annual mortgage insurance premium and a new policy that will require borrowers to pay annual premiums for the life of the loan rather than to cancel them after the outstanding principal balance reaches 78 percent of the original principal balance. FHA will also now require lenders to manually underwrite loans of borrowers that have a credit score below 620 as well as a total debt-to-income ratio greater than 43 percent, and it will be issuing a proposal for public comment regarding increasing down payment requirements for mortgages that have original principal balances above $625,000 from 3.5 percent to 5 percent.

Economic Net Worth by Book-of-Business



Source: FY 2012 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

As a result of these and other changes enacted since 2009, the newer books of business, especially 2011 and 2012, are together expected to bolster the agency's reserves by over $19 billion, according to recent estimates from the recent FHA actuarial review.[38]

E. Recent Attacks on the FHA model are Inconsistent with the Facts

As noted above, FHA appears to be returning to "normal" profitability, just as it has after playing a countercyclical role in the past. New business is significantly less risky and will likely perform better than any books of business in the agency's history. If anything, FHA's insurance activities have become more conservative than ever before.

However, critics continue to attack FHA's basic business model. For example, in December 2012, the American Enterprise Institute released a report written by Ed Pinto entitled "How the FHA Hurts Working-Class Families and Communities." The author seizes on reported losses at FHA in the wake of the crisis to portray FHA as a destabilizing force while omitting the context surrounding the loss and the way in which FHA stabilized the U.S. housing market during the housing and financial crisis.

Pinto has come up with projected losses that far exceed those predicted by other analysts; a major reason for this is that his analysis fails to take into account both the superior performance of FHA loans vis-à-vis PLS loans, and changes made to FHA's business meant to improve its bottom line. Furthermore, the report fails to take into account any of the policy changes that FHA has made to improve its financial position, ranging from the elimination of the seller-funded down-payment program to the numerous increases in insurance premiums.

In addition, the Pinto report examines the 2009-2010 book years, which Pinto considers as "well after the market's collapse," and therefore (presumably) a neutral period of time in which to evaluate FHA's lending.[39] In fact, the dataset begins just months after the government bailed out the nation's major financial institutions, Fannie Mae and Freddie Mac entered conservatorship, credit markets froze, unemployment spiked, and housing prices were in free fall. The 2009 book also still includes a sizable chunk of seller-funded down-payment-assistance loans.

Perhaps most misleadingly, Pinto presents a correlation between FHA and high foreclosure rates in distressed communities as if to imply that the FHA is responsible for the high foreclosure rate. The concentration of FHA loans and the high rates these communities are largely a result of the unsustainable private subprime mortgages pushed in these communities during the housing bubble. FHA was one of the only lenders supporting the housing market in these distressed communities at the height of the foreclosure crisis because most private lenders had fled the credit risk of such neighborhoods. FHA's presence helped to stabilize the neighborhood—not a cause but a consequence of the neighborhood's financial distress.

Although Pinto characterizes FHA's loans as inherently risky because of borrower characteristics, the trigger for the housing crisis was not risky borrowers, but risky loans.[40] FHA loans are fully amortized, fixed-rate loans, a stark contrast to interest-only or even negative-amortization mortgages that were available during the housing bubble. This higher loan quality is reflected in the relative default rates of FHA loans and subprime mortgages. While the serious delinquency rate on subprime loans reached over 30 percent in 2009, the serious delinquency rate of FHA-insured loans has hovered around 9 percent since 2009.[41]

As Pinto pointed out in the recent report, average interest rates were higher for African American and Hispanic borrowers in the lead-up to the financial crisis. This fact is not surprising, though, since privately funded predatory lending targeted communities of color, often upselling those families into higher-cost and riskier loans than they otherwise would have qualified for.[42]

Indeed, had FHA followed Pinto's ill-supported advice and refrained from lending in distressed neighborhoods, the agency would not have been able to play its critical countercyclical role following the crisis. Many of the neighborhoods that are now entering a recovery period likely would have been lost for good.

F. A Few Recommendations Going Forward

As the housing market recovers, FHA's share should and will return to its historical norms. But as long as the GSEs are in conservatorship and private mortgage lenders continue to stay on the sidelines, FHA will remain a crucially important option for ensuring that affordable mortgage capital remains available for potential homebuyers.

It is now important to give sufficient time to see the results of the significant improvements made by FHA before adding still more changes to the mix. If too many changes are made at once, there is a serious risk of overcorrection that will have negative repercussions in the housing market. In particular, further tightening underwriting standards at this time will likely reduce both FHA's volume and the overall size of the mortgage market and put downward pressure on home values – limiting FHA's ability to play the countercyclical role. Such a move could negatively affect FHA's financial health in the long run, as the agency is so dependent on the health of the housing market.

FHA does need to continue to explore how to improve risk estimates on FHA insurance, a problem that they have been grappling with for years. But it would be a mistake to approach this problem by intentionally inflating the cost of that risk through so-called "fair-value budget reporting." Instead of improving the accuracy of cost estimates for credit programs, it actually makes them less accurate by biasing apparent costs upward, and distorts the government's true fiscal position.[43] It could cause serious harm to programs such as FHA while doing nothing to actually reduce taxpayer exposure to loss. Instead, it is largely a back-door way to scale back the government's footprint under the guise of "responsible" budgeting.[44]

FHA also can take additional steps to improve its loss mitigation efforts, since providing borrowers with alternatives to foreclosure helps homeowners, the FHA insurance fund, and home values in neighborhoods – a win-win-win proposition. FHA has recently updated its loss mitigation requirements, including a revised set of alternatives to foreclosure that every servicer must consider before completing a foreclosure, but to increase compliance, FHA should require that a servicer provide clear proof that it complied with these new guidelines before it pays out an insurance claim.

Also, FHA should require that its loan servicers give homeowners notice describing FHA's loss mitigation option and develop an effective mechanism through which homeowners can address a servicer's non-compliance with FHA's loss mitigation requirements. In addition, since FHA's loss mitigation guidelines are embodied in a disorganized series of bulletins and letters that neither homeowners nor servicers can access easily, it would help for FHA to develop a concise handbook describing FHA's loss mitigation options that is available to the public and easily understood.

Finally, there are some areas in which FHA needs additional authority from Congress to manage its risk as effectively as possible. These areas include revised indemnification authority, greater flexibility related to the Compare Ratio requirement, and additional servicing transfer authority.[45] It is our understanding that FHA will provide more information about these requests in this Committee's hearing on February 13, 2012.

Conclusion

FHA plays a key role in helping creditworthy homebuyers – especially those of modest means – obtain access to credit to purchase a home. Owning a home provides economic and social stability for middle-class families, builds wealth that can be leveraged and transferred across generations, and encourages residents to maintain their properties and invest in their communities.

Because of FHA's importance to the market, the agency should take prudent and targeted steps to restore the financial health of the insurance fund. But even if the agency does require support from the U.S. Treasury in the coming months, it will still have saved taxpayers billions of dollars by preventing massive home-price declines, another wave of foreclosures, and millions of terminated jobs. Considering the strength of the agency's recent books of business, any temporary assistance would almost certainly be paid back over a reasonable time frame.

Beyond FHA, the time is now to have a larger conversation about the future of housing finance in America. Fannie and Freddie cannot remain in conservatorship indefinitely, and a vibrant housing market cannot be built simply on refinancing. The market needs a steady supply of first-time homebuyers who can then become move-up homebuyers. Many of these buyers will be people of color or young people shouldering student debt, and they may not have the means to put twenty percent down. Important questions must be resolved about how to bring private capital back into the market, how to minimize government and taxpayer support while still providing long-term, sustainable lending, and how to serve the buyers of the future.

I welcome the opportunity to discuss these important matters with you over the coming year. Thank you again for inviting me today, and I look forward to your questions.

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[40] Julia Gordon, Testimony before the House of Representatives Subcommittee on Insurance, Housing and Community Opportunity, "Are There Government Barriers to the Housing Market Recovery?" February 16, 2011, available at http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/Gordon-HFS-Biggert-testimony-final.pdf.
[41] Mortgage Bankers Association, National Delinquency Survey
[42] *United States v. Wells Fargo Bank*, 1:12-cv-01150-JDB (D.D.C. 2012), available at: http://www.justice.gov/crt/about/hce/documents/wellsfargocd.pdf; see also Janet Paskin, "Higher Rates for Blacks and Hispanics?" *The Wall Street Journal: Total Return Blog*, July 12, 2012, available at http://blogs.wsj.com/totalreturn/2012/07/12/higher-rates-for-blacks-and-hispanics/
[43] Jim Horney, Richard Kogan and Paul Van de Water, "House Bill Would Artificially Inflate Cost of Federal Credit Programs," (Washington: Center on Budget and Policy Priorities, 2012), available at http://www.cbpp.org/cms/index.cfm?fa=view&id=3661.

[44] For more information about fair-value budget reporting, see John Griffith, "An Unfair Value for Taxpayers," (Washington: Center for American Progress, 2012), available at http://www.americanprogress.org/issues/budget/report/2012/02/09/11094/an-unfair-value-for-taxpayers/

[45] Donovan, Testimony before the Senate Banking Committee

TESTIMONY

Establishing the Proper Role of the Federal Housing Administration in The U.S. Mortgage -Finance System

Basil N. Petrou
Managing Partner
Federal Financial Analytics, Inc.

Before the

Committee on Financial Services

United States House of Representatives

February 6, 2013

It is an honor to appear before this Committee today at its first hearing of the 113th Congress under the leadership of Chairman Hensarling and Ranking Member Waters to testify on the proper role of the Federal Housing Administration (FHA) single-family mortgage insurance program in the U.S. mortgage-finance system. FHA plays a vital role, but it may well supplant private capital that can and should be deployed to reduce taxpayer risk in a vital sector: low down-payment mortgage loans for first-time homebuyers and others without the equity to purchase a home, refinance an existing loan that is now high loan-to-value or "move up" in a prudent fashion. Further, FHA is just one element in the U.S. Government's role and its risk related to residential mortgage finance. In your request for testimony today, the Committee rightly made clear that setting the right role for FHA must be done with a clear vision of the overall stand the federal government will play in residential mortgage finance. Like I think most if not all Members of this Committee, I believe the taxpayer should take as little risk in this sector as possible, standing back now that the crisis is ebbing to permit private capital to re-enter this sector under a new regulatory framework robust enough to prevent past abuse of borrowers and investors.

I am Basil N. Petrou, managing partner of Federal Financial Analytics, a firm that provides consulting services on, among other things, the array of policy issues affecting single-family residential mortgage finance.[1] As the Committee has requested, I will focus my remarks today on whether FHA's 100 percent federal guarantee distorts mortgages in the U.S. financial system, if high-income borrowers who otherwise would be eligible for privately-insured loans should still avail themselves of FHA-insured loans and on policies that thwart efforts by the private sector to revive and strengthen their role in this vital arena.

Because the Committee has rightly noted that FHA reform is only one element of urgently-needed broader housing-finance reform, I will briefly summarize the relationship of FHA not just to the future of Fannie Mae and Freddie Mac, but also to many pending changes to financial-market regulation in the wake of the 2008 crisis and the passage of the Dodd-Frank Act. FHA is a critical market driver and source of taxpayer risk, but it is not the only force redefining U.S. housing finance. To consider it in a "silo" may lead to neglect of other pending policies that – even if FHA reform is speedily enacted in meaningful fashion – still may not fully support a vibrant mortgage-finance system largely reliant not on taxpayers, but rather on private capital.

With specific regard to FHA, I recommend that:

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[1] Since 1985, Federal Financial Analytics, Inc. has provided analytical and proprietary advisory services to private corporations and government agencies in the U. S. and other major financial centers. The firm's practice includes a focus on U. S. residential-mortgage finance, including analysis of legislative, regulatory and policy matters governing issues such as the role of the FHA, the structure of the GSEs, pending efforts to reform asset-backed securities, U. S. and global regulatory-capital regulation and similar matters. The firm has frequently testified before the U. S. Congress on these matters (see WWW.FEDFIN.COM) and has otherwise been honored to participate in the public debate on these vital matters. Federal Financial Analytics, Inc. does not lobby on behalf of any clients.

- Congress should reduce the 100 percent full-faith-and-credit guarantee provided by the FHA to parallel the limited coverage of 25% to 50% successfully used by the Veterans Administration (VA) for the mortgages it has guaranteed for several decades. Reducing coverage levels will effectively cap the severity of loss on FHA loans and improve their underwriting by putting the lender at risk. It is simply impossible for there to be real incentive alignment between mortgage originators and the taxpayer if originators take all the profit and the U. S. taxpayer takes all the risk. Further, expansion of housing programs with the full-faith-and-credit backstop distorts the U. S. financial system and global capital markets because capital regulations and many other requirements strongly favor obligations of this sort over those backed by private capital, creating a high barrier to the re-entry of private capital to U. S. residential-mortgage finance.

- The FHA should be targeted to borrowers based on income, not home price. Currently, high-income low down payment borrowers are often eligible for full-faith-and-credit U.S.-backed mortgages even though the private market for their mortgages would otherwise be deep, liquid and efficient. When the U. S. Government (USG) supports mortgage finance for higher-income borrowers, it supplants private capital otherwise ready to take on this risk and creates market distortions because of the lack of market discipline applicable to these larger loans.

- Current FHA policy should be significantly revised with regard to delegating underwriting to the loan originator and reviewing underwriter performance only after the fact. Instead, FHA should be authorized to share risk with regulated, capitalized providers of private credit –risk enhancement for mortgages (if unaffiliated with the originator). This deep source of private capital would conduct a second underwriting prior to loan origination, applying discipline derived from the incentive alignment between the FHA and private providers of credit-risk mitigation based on shared risk.

- A strict capital requirement should be set for the FHA single-family fund incorporated through a new actuarial model that accurately predicts losses. Additionally, the budgetary treatment of FHA should be changed to reflect the fair value analysis recommended by the Congressional Budget Office (CBO) currently applies to the budget treatment of the GSEs.

Reflecting the above recommendations for FHA in the broader framework of U.S. mortgage-finance regulation and government intervention, I recommend that:

- Congress should work to ensure that an array of pending prudential rules for banks (e.g., those implementing the Basel III capital and liquidity rules) do not so favor USG-backed mortgages as first to block the re-entry of private capital and, second, to prevent constructive reform of Fannie Mae and Freddie Mac. Although many pending rules would exempt the GSEs in conservatorship, treating them essentially the same as FHA, the conservatorships should end as quickly as possible. Once that occurs, if the U.S. financial-market regulatory framework creates only strong incentives for reliance on USG obligations, then mortgage risk will flood into the FHA, putting taxpayers at acute risk even if all of the reforms outlined above are in place.

- A critical pending rule would implement the risk-retention provisions of the Dodd-Frank Act, creating a new "qualified residential mortgage" (QRM) criterion that would exempt loans from costly risk retention. Although down-payment and loan-to-value (LTV) requirements are a key prudential factor, the QRM should not (as proposed) set a simple down-payment requirement without regard to the use of regulated, capitalized providers of credit-risk mitigation like private mortgage insurers. Doing so would make it extremely difficult to securitize high-LTV loans for first-time home-buyers and other borrowers who can prudently manage low down-payment mortgages demonstrated by careful underwriting backed by private capital at risk. If the QRM advances as proposed, these loans will flood into the GSEs and FHA and, once the conservatorships are closed, then only into the FHA.

<u>The Risks Covered by Mortgage Insurance</u>

When providing credit-risk mitigation (CRM) against default by a borrower, insurers face two key risks: first, the probability that a loan will go into default and, second, the severity of loss – that is, the amount the insurer will have to pay based on factors such as house-price depreciation, foreclosure costs and property damage. While much attention has been paid to the probability of default on the loans FHA insures, the severity of default risk to which FHA is exposed with its 100% coverage is at least as important when considering taxpayer risk.

FHA's 100% Guaranty

The FHA complete guaranty of mortgage risk distorts the incentive structure for lender/servicers and puts the taxpayer at unnecessary risk. There are three simple points that demonstrate that 100% FHA insurance coverage is self-defeating for FHA and the U.S. taxpayer:

1. FHA is exposed to severe losses on every loan that goes to claim during a house-price decline such as that experienced since 2006;
2. FHA exposes itself to fraud and poor underwriting that would not otherwise occur if the loan originator had "skin in the game" on every FHA-insured loan it originates; and
3. Reducing the level of insurance coverage on future FHA loans while holding the FHA premium at its current level would recapitalize the FHA MMI fund with positive budget scoring.

As noted by the Department of Housing and Urban Development (HUD) Inspector General, "[a]s a mortgage insurer, FHA pays the ultimate cost of loans that go bad. Lenders are made whole, but FHA seldom recovers that cost in reselling the properties to the public."[2] When the HUD IG made this statement in 2007, he noted that "FHA loses an average of 30% of each insurance claim it pays, when sales costs are netted against the payout to the lender/claimant." [3] By 2008 the loss severity rate for non-HECM FHA-insured loans that went to claim in that year had soared to over 62% and, by 2010, the loss-severity rate had stabilized at 48%. That is, by insuring 100% of the loan amount, FHA is now losing 50% of its insured amount. [4]

There is no market or policy reason why FHA has to expose itself to this level of loss severity on insured loans. Indeed, the experience of the VA-guaranteed mortgage program demonstrates that lowering the level of insurance coverage reduces both the severity of loss and the probability of default.

FHA, VA and Ginnie Mae

The FHA and its government securitizer, the Government National Mortgage Association (Ginnie Mae), provide investors in single-family mortgage backed securities (MBS) with a security that is completely backed by the U.S. taxpayer. Ginnie Mae does not issue MBS, but approves the private lenders who issue MBS for which it provides the

[2] Statement of Kenneth M. Donohue, Inspector General, Department of Housing and Urban Development Before the Senate Committee on Banking, Housing, and Urban Affairs, July 18, 2007.
[3] Ibid.
[4] Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012, November 5, 2012, p. E-3.

backstop guaranty. The issuers advance payments of principal and interest to the MBS investor when a loan underlying the MBS defaults. It is then that the government insurance (primarily FHA and VA) repays the issuers. However, the investor in the Ginnie Mae MBS does not worry about the ability of the issuer to make a payment because Ginnie Mae insures the performance of the issuers and provides the MBS investor with a complete and explicit government guaranty on the timely payment of principal and interest. Private entities cannot provide investors with a similar taxpayer-backed guaranty and consequently Ginnie Mae securities are better priced than even MBS backed by the GSEs.

In the marketplace, this favored position for Ginnie Mae-backed securities should be passed through to the mortgage borrower in the form of the lowest interest rate available given the prepayment risk associated with the mortgages underpinning the MBS. To the extent this is the case, the U.S. taxpayer is providing both the MBS investor and the homeowner utilizing the government-backed mortgage significant benefits at a potential cost to the taxpayer that will be reduced by lowering the FHA coverage level so as to cap potential losses while targeting FHA only to borrowers who cannot achieve sustainable homeownership without government support.

<u>VA Coverage Levels Adequately Support Ginnie Mae</u>

As Ginnie Mae notes in its annual report, it "absorbs losses only after all other mortgage safeguards (homeowner equity, mortgage insurance, and lender resources) are exhausted, thus minimizing risk to the taxpayer."[5] In the case of FHA-insured loans, FHA provides Ginnie Mae with a complete government guarantee in the event the issuer fails in its obligation to make a payment, but the same is not the case for VA-guaranteed mortgages that back Ginnie Mae MBS. The VA guaranty varies from 25% to 50% of the mortgage loan amount with the coverage falling as the loan amount increases.[6] However, from the MBS investor's point of view, the explicit U. S. guarantee of timely payment of principal and interest backed by Ginnie Mae remains the same for the MBS composed of FHA and VA loans. So, when an issuer fails to meet its obligations, Ginnie Mae steps in to provide the MBS investor with the timely payment of principal and interest. Ginnie Mae then acquires control of the issuer's mortgage servicing rights and places the portfolio with a financially-sound master subservicer. As Ginnie Mae notes, "it is through investors' confidence in this sustaining model that Ginnie Mae ensures that capital continues to flow to the Nation's housing finance system." [7]

What is clear, however, is that 100% insurance coverage by FHA is not necessary to facilitate investor confidence in the ability of Ginnie Mae to guarantee the timely payment of principal and interest. Indeed, the much more limited VA guarantee combined with Ginnie Mae's power to acquire an issuer's mortgage servicing rights is a superior structure to the 100% FHA guarantee since it protects the U.S. taxpayer from both a high probability of default and high severity of loss on defaulted mortgages.

[5] Government National Mortgage Association Annual Report 2012, November 13, 2012 letter from Theodore Tozer to HUD Secretary Shaun Donovan (p.2).
[6] Under 38 USC Sec. 3703 the guaranty amount for a borrower with full entitlement is 50% for loans of $45,000 or less; $22,500 for loans greater than $45,000, but no more than $56,250; the lesser of $36,000 or 40% of the loan amount for loans greater than $56,250, but no more than $144,000 or; 25% of the loan amount for loans of $144,000 to $417,000; or for certain loans in excess of $417,000, the guarantee will be the lesser of:25% of the county loan limit or 25% of the loan.

VA Loans Perform Better Than FHA Loans

Clearly, the limited coverage of VA-guaranteed loans puts the issuer's capital at risk instead of the US taxpayer's in the event the loss severity of a loan exceeds the VA insured amount. However, the fact that the issuer is placed at potential risk on each and every VA-guaranteed loan means that the issuer is inevitably going to perform a thorough underwriting to protect its own capital. This is critical in programs such as VA and FHA, where the underwriting is delegated to the lender/issuer.

The default data for VA and FHA loans validates this point. Data collected by the Mortgage Banker's Association (MBA) show that VA-guaranteed loans have experienced serious delinquencies at a rate that ranges from 50% to 60% of the comparable rate for FHA-insured loans.[8] In fact, since 2009, the serious delinquency rates for VA-guaranteed loans have been lower than the comparable rate for prime loans.[9] The significantly better performance of VA-guaranteed loans as compared to FHA-insured loans has been consistent for years and generally holds regardless of the geographic location of the loan.[10]

Importantly, the better performance of VA-guaranteed loans is not an aberration and cannot be attributed to the size of the program. At the end of FY 2012, VA-guaranteed loans accounted for 32% of all outstanding Ginnie Mae guaranteed

[7] Ginnie Mae 2012 Annual Report, p.7.
[8] See for example The National Delinquency Survey for the Third Quarter of 2012, published by the Mortgage Banker's Association of America, pp.11.
[9] Ibid., p.10.

issuances.[11] With $384 billion of outstanding VA-guaranteed mortgages underpinning Ginnie Mae MBS, the VA program and its default experience has become a major factor in the mortgage market. Indeed, VA-guaranteed mortgage originations in calendar year 2012 totaled $129 billion, equivalent to 53% of the total FHA single family originations.[12]

While other factors might contribute to the better performance of VA loans, limited insurance coverage and the lender's exposure to loss on every loan inevitably means that better underwriting occurs.

Applying Reduced Coverage Levels to FHA

As noted, VA coverage levels fall as the loan amount increases but only range between 50% and 25% of the loan amount, with the average coverage in the 25% to 30% range. Coverage by private MIs varies by initial LTV, with the GSE charter requirements bringing the initial LTV down to below 80%. Currently, this generally means coverage levels of 25% to 30%, although in the past deeper MI coverage to 35% has been required by the GSEs.

In order to facilitate a smooth transition to reduced coverage levels, it is appropriate for FHA to set a single coverage level of 30%, with the only exceptions made for loans in inner-city, low-income areas or other geographic areas where the value of the underlying property is uncertain. For these areas, a coverage level above 30% might be

[10] Ibid.,p.6.
[11] Ginnie Mae 2012 Annual Report, p. 10
[12] See *Inside Mortgage Finance*, February 1, 2013, p.4

appropriate, but it should not exceed the 50% coverage level that applies to lower dollar amount VA-guaranteed loans.

As Ginnie Mae starts to deal in FHA-insured mortgages with less than 100% coverage, it should be given the authority to increase its guarantee fee to the issuer. The guarantee fee has been fixed in law at 6 basis points for decades, but, this may no longer be sufficient to deal with a program where all loans backing a Ginnie Mae security have less than 100 percent insurance coverage. If a higher guarantee fee is needed to compensate Ginnie Mae for any new risk, Ginnie Mae will have to be granted the flexibility to increase its guarantee fee.

Other Reforms to FHA

Reducing the coverage level of FHA-insured loans will be the most positive step that Congress could take to improve the performance of the FHA single-family program. However, below are several other changes that would assure that the taxpayer backstop in FHA is only targeted to qualified borrowers who do not have access to other financing sources.

1. Target the FHA Using Borrower Income and Not House Prices

   The current system of setting FHA eligibility by loan size, not borrower income, contradicts the purpose of government intervention: serving only those whose needs cannot be met by markets when these needs meet agreed-upon policy goals. A government program must focus on the people it serves.

This is best determined by looking at the actual individuals using a program, not at abstract indicators, proxies, or substitute factors. It is time that FHA becomes an income-targeted – rather than a loan amount targeted – housing program. The current system for setting FHA area loan limits raises them above true median house prices, never lowering them even if house prices fall. Indeed, the current FHA nationwide base limit of $271,050 is significantly higher than the national median existing house price of $176,600[13] which means that entire states where house prices are comparatively low now have an FHA loan limit that greatly exceeds the median house price anywhere in the state. Income targeting FHA's single-family program will assure that low- and moderate-income borrowers become the primary focus of the program and not borrowers who can afford large loans even when interest rates increase.

2. Fix the FHA MMI Fund Actuarial Review Process

The model used by FHA for assessing the actuarial value of its single-family insurance fund is not working. Since 2007, the current model—even with the changes made over the years—has consistently over-estimated the economic value of the MMI Fund and the economic value of each new year's book of business. As the HUD Inspector General noted last year, "FHA continues to project that the current and future year's books of business will be profitable and make up for these past years losses. However, what we have seen in the past three years is a troubling trend whereby the point at which the Fund is

[13] See National Association of Realtors Report on Existing Home Sales, January 22, 2013 available at: http://www.realtor.org/topics/existing-home-sales/data

expected to reach its mandated capital level is pushed farther into the future."[14] Similarly, in 2010, the outside firm hired by the HUD IG to review the independent actuary's report on the MMI Fund concluded that the "design of the current model does not provide an effective way to communicate risks."[15] Finally, the most recent report of the HUD IG on FHA finances noted that as of the end of FY 2012 the capital reserve account of the single family fund had insufficient funds to cover the re-estimate of expected higher losses.[16] Every year, FHA sends to Congress a re-estimate of the performance of its books of business and, every year, the re-estimate has been adverse to the Fund. Clearly, changes have to be made for Congress to receive a correct and timely update as to whether or not FHA will require a taxpayer bailout.

3. Correct the Budget Accounting for the FHA Program

The Congressional Budget Office prepared a report in 2011[17] that noted the differences between the current budget accounting methodology for FHA and fair-value estimate which incorporates a market-based risk premium that recognizes the financial risk that the government assumes when issuing credit guarantees. This fair-value estimate is more costly to U.S. taxpayers but it shows the true cost of government guarantee program. The fair-value approach

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[14] Testimony of the Honorable David A. Montoya, Inspector General, U.S. Department of Housing and Urban Development, Before the U.S. House of Representatives Committee on Appropriations, Subcommittee on Transportation, Housing and Urban Development, and Related Agencies, March 29, 2012, p.4.

[15] Independent Auditor's Report to the HUD IG, 2011-FO-0002,Audit of Financial Statements for FY 2010 and FY 2009, dated November 5, 2010attached to letter from HUD IG to David Stevens, FHA Commissioner, Appendix A, p.14.

[16] Independent Auditor's Report to the HUD IG, 2013-FO-0002,Audit of Financial Statements for FY 2012 and FY 2011, dated November 9, 2012 attached to letter from HUD IG to Carol Galante, Acting FHA Commissioner, p.7 (referencing Note 6).

is used by CBO to assess the GSEs and it should be used to assess the operations of FHA. As CBO noted, the application of a fair-value approach to FHA increases the estimated subsidy rate of the single-family program to such a degree that the program would show a cost rather than savings. Importantly, the fact that the GSEs are accounted for under CBO's budget on a fair-value basis, while FHA's is scored under FCRA accounting, distorts incentives to expand the FHA program without recognizing its true cost. As CBO noted, "because costs recorded on a FCRA basis are generally below fair value, if legislation would cause mortgage borrowers who would otherwise obtain a guarantee from Fannie Mae and Freddie Mac to instead use an FHA program on the same terms, the legislation could appear to produce budgetary savings, even though the government's exposure to losses from defaults would be identical."[18]

4. Authorize FHA to Develop a Risk Share Program with Private Providers of CRM for Residential Mortgages

   As a program where the mortgage underwriting is delegated to the lender/issuer, the FHA exposes itself to the risk that poor underwriting will only be found after a loss occurs. It is important that the taxpayer be protected at the front end of loan origination from poor FHA-delegated underwriting. FHA should thus be authorize to engage in risk shares with private providers of credit-risk mitigation for residential mortgages. Eligible CRM providers here should be:

[17] Report from Douglas W. Elmendorf to Congressman Paul Ryan, May 18, 2011, Accounting for FHA's Single Family Mortgage Insurance Program on a Fair Value Basis.

- regulated under either state or federal standards acceptable to HUD as established by rule;
- expressly subject to rules that bar correlation of risk between the CRM provided for FHA and other mortgage-finance activities; and
- unaffiliated with any loan originator making use of FHA.

Eligible private CRM providers would then separately underwrite each insured loan to verify that the lender/issuer is following the jointly agreed upon process of loan underwriting and verification of borrower income, credit, debt service and other key underwriting criteria. By putting the private insurer on the same risk with FHA, the taxpayer will be protected by both its private capital and its private loan underwriting expertise.

Conclusion

At the outset of this statement, I indicated that FHA reform couldn't be viewed in isolation from pending regulatory developments or – even more importantly – the need quickly to determine a course for Fannie Mae and Freddie Mac that brings them out of conservatorship. Together, FHA, Fannie Mae and Freddie Mac now dominate the U.S. residential-mortgage market. Private capital will only be attracted to the mortgage space when and if it becomes clear that market has been reopened through the retreat of the government. Today, a combination of regulatory uncertainty and the crushing impact of

[18] Ibid.,p.6.

a U.S. Government guarantee quash the ability of private capital to invest in the new systems and develop the new products necessary to originate, service and securitize loans to advance credit availability without sowing the seeds of another systemic crisis.

The huge role of the U.S. Government in mortgage finance means that Congress should advance FHA reform in tandem with other changes. For example, putting Fannie Mae and Freddie Mac into a new form that terminates the conservatorship might promote private capital, but not if FHA continues its 100% guarantee at current loan levels without appropriate originator discipline or risk-sharing with appropriate sources of private capital. One-sided GSE reform will only drive still more risk to taxpayers through FHA, an especially dangerous prospect given the many systems and risk-management problems that have brought FHA to the parlous condition revealed in its most recent actuarial report.

American Enterprise Institute
for Public Policy Research

Statement before the Committee on Financial Services
U.S. House of Representatives
On "Examining the Proper Role of the Federal Housing Administration in our Mortgage Insurance Market"

Edward J. Pinto
Resident Fellow
American Enterprise Institute

February 6, 2013

The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Hearing before Committee on Oversight and Government Reform
U.S. House of Representatives

Submitted testimony by Edward Pinto, resident fellow of the American Enterprise Institute.

Chairman Hensarling and Ranking Member Waters, thank you for the opportunity to testify today.

Introduction

I recently completed a comprehensive study that shows the FHA is engaging in practices resulting in a high proportion of low- and moderate-income families losing their homes. Based on an analysis of the FHA's FY 2009 and 2010 books of business, the FHA's lending practices are inconsistent with its mission and represent a disservice to American working-class families and communities.

The findings of this study indicate:

- An estimated 40 percent of the FHA's business consists of loans with either one or two subprime attributes—a FICO score below 660 or a debt ratio greater than or equal to 50 percent (based on loans insured during FY 2012). The FHA's underwriting policies encourage low- and moderate-income families with low credit scores or high debt burdens to make risky financing decisions—combining a low credit score and/or a high debt ratio with a 30-year loan term and a low down payment. A substantial portion of these loans have an expected failure rate exceeding 10 percent.
- Across the country, 9,000 zip codes with a median family income below the metro area median have projected foreclosure rates equal to or greater than 10 percent. These zips have an average projected foreclosure rate of 15 percent and account for 44 percent of all FHA loans in the low- and moderate-income zips.

The study found the direct and indirect costs associated with a foreclosure rate greater than 10 percent, particularly in working-class communities, are unacceptably high. Risk layering, combined with high FHA loan volumes, has a substantial impact on these communities. The resulting reduced or declining home values impact FHA and non-FHA low- and moderate-income families diligently making their payments. These families may be denied the opportunity to build equity, provide security for their family, and have the down payment for their next home as their family grows. Foreclosures also result in increased blight and crime and the larger community suffers from a reduced tax base and higher costs for providing municipal services.

The study identified specific reforms to focus the FHA on responsible lending and return it to its traditional mission:

Step 1: Do not knowingly insure a loan with a projected claim termination rate greater than 10 percent, assuming no house price appreciation or depreciation.

Step 2: Target an average 5 percent projected claim termination rate, assuming no house price appreciation or depreciation.

Step 3: Stop guaranteeing lower-risk loans and high-dollar-balance borrowers, as this allows for cross-subsidization of those loans with excessive risk. This will also let the FHA step back from markets that can be served by the private sector and allow it to concentrate on home buyers who truly need help.

Step 4: Price for risk, since not doing so deprives the borrower of the price information needed to understand the true risk of the loan. Until this is done, the FHA should disclose to the borrower his or her expected claim rate, assuming no house price appreciation or depreciation.

Step 5: Implement underwriting that results in the extension of responsible mortgage credit, by balancing down payment, loan term, FICO score, and debt-to-income ratio to achieve meaningful equity.

The Problem:

> *Given FHA's mission, allowing the continuation of practices that result in . . . a high proportion of families losing their homes represents a disservice to American families and communities.*[1]

Based on an extensive analysis of the Federal Housing Administration's (FHA's) FY 2009 and 2010 books of business,[2] it is violating its own standard.

Most can agree with the FHA's mission to help creditworthy low- and moderate-income Americans and first-time home buyers by providing responsible mortgage credit that leads to homeownership success and neighborhood stability. That said, the real question is: what is the tolerance for failure? All lending entails risk. At what level of failure does lending become abusive because the direct and indirect costs associated with a high foreclosure rate are unacceptably high for FHA borrowers and the affected community?

The findings of this study indicate:

- An estimated 40 percent of the FHA's business consists of loans with either one or two subprime attributes—a FICO score below 660 or a debt ratio greater than or equal to 50 percent (based on loans insured during FY 2012).
- The FHA's underwriting policies encourage low- and moderate-income families with low credit scores[3] or high debt burdens to make risky financing decisions—

[1] US Housing and Urban Development Department, "Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements" (notice of proposed rulemaking), July 15, 2010, www.federalregister.gov/articles/2010/07/15/2010-17326/federal-housing-administration-risk-management-initiatives-reduction-of-seller-concessions-and-new#p-31.
[2] Tabulations based on an analysis of the FHA's FY 2009 and 2010 books, which data were provided upon request by Genworth Financial. Data provided with respect to 2.4 million loans, which is estimated to represent 75 percent of 3.45 million loans insured by the FHA for these two book years.
[3] The median FICO score is about 720. Twenty-one percent of individuals have a score below 620. The remaining 79 percent have a score between 620 and 800+, the effective score range for prospective home

one combining one or both a low credit score or a high debt ratio with a 30-year loan term and a low down payment.

- A substantial portion of these loans have an expected failure rate exceeding 10 percent.
- Once the expected failure rate exceeds 10 percent, the resulting direct and indirect costs to low- and moderate-income families and communities are a disservice to the very families and communities it is the FHA's mission to help.

Background

> *By the mid-1950s FHA had demonstrated the feasibility of [relatively high LTV] lending, given the sound underwriting and appraisal standards it pioneered.*[4]

Many look at today's FHA and nostalgically recall their great-grandmother's Depression-era FHA. Set up in 1934, it insured fully amortizing 20-year term loans combined with a minimum 20 percent down payment. As late as 1954, down payments and terms on FHA loans still averaged about 20 percent and 20 years, respectively.[5] As a result, home buyers accumulated nearly 30 percent in earned equity[6] after four years. Additionally, housing debt and total housing expense ratios[7] averaged 15 percent and 19.5 percent, respectively, helping to cushion any adverse income shocks.[8] This helps explain why, over its first 20 years, the FHA paid only 5,712 claims out of 2.9 million insured mortgages for a cumulative claims rate of 0.2 percent. At the same time, claim loss severity was only 9 percent of the original insured mortgage balance, or a total of $3 million on 5,712 claims.[9]

By the mid-1950s, the FHA had demonstrated the benefits of sound underwriting principles built upon 30 percent earned equity build-up over four years and a modest mortgage debt burden of 15 percent. The FHA began to abandon those principles in the late 1950s. Since

ownership today since the FHA insures few loans where the borrower has a score below 620. The 620 to 659 score group is served almost entirely by the FHA and accounts for about 15 percent of prospective homeowners with scores above 620. Individuals with a score between 620 and 659 have a much higher risk of default than borrowers with higher scores. Source for FICO score distribution information: Board of Governors of the Federal Reserve System, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, August 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf.

[4] Department of Housing and Urban Development, *The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market*, November 2012, www.huduser.org/portal/publications/hsgfin/fha_singlefamily2012.html.

[5] John P. Herzog and James S. Earley, *Home Mortgage Delinquency and Foreclosure* (Cambridge, MA: National Bureau of Economic Research, 1970), www.nber.org/books/herz70-1.

[6] The combination of down payment and scheduled amortization.

[7] Herzog and Earley, *Home Mortgage Delinquency and Foreclosure*. Housing debt is the total of principal, interest, taxes, and insurance (PITI). Total housing expense (a concept no longer in use) includes PITI plus utilities, maintenance, and repair costs. It generally added about 5 percent to the housing debt ratio.

[8] Ibid.

[9] Thomas N. Herzog, *History of Mortgage Finance with an Emphasis on Mortgage Insurance*, Society of Actuaries, 2009, www.soa.org/library/monographs/finance/housing-wealth/2009/september/mono-2009-mfi09-herzog-history-comments.pdf.

then, the FHA's role has been that of the leverage leader, spurring the housing finance industry and borrowers to multiple forms of increasing leverage.

Borrower leverage takes six forms, and the FHA has promoted the simultaneous and excessive use of each, particularly with respect to low- and moderate-income families and communities.

Two types of asset leverage:

1. As the down payment percentage decreases, the asset price of the home it can leverage increases.
2. As the loan amortization term increases, asset leverage remains high because of slower earned equity buildup from amortization during a loan's early years.

Three types of income leverage:

3. As the debt-to-income ratio increases, so does the loan that may be serviced with the same amount of income.
4. As the loan amortization term increases, so does the loan that may be serviced with the same amount of income.
5. As the rate of interest declines, the size of the loan that may be serviced with the same amount of income rises. While the Federal Reserve is responsible for this increase in leverage, the FHA's underwriting policies turn virtually all of this additional buying power into increased buyer leverage.

One type of credit leverage:

6. The lower the acceptable credit score, the larger the pool of buyers. Data are not available to track this expansion back to the 1950s.

Lulled by its early success, encouraged by a housing lobby grown dependent on increasing leverage, and faced with private-sector competition for the first time,[10] the FHA, at the behest of Congress, moved further and further out the risk curve until a down payment of less than 5 percent, a loan term of 30 years, and a mortgage debt burden more than double the level in 1954 became the norm. For a borrower at the maximum loan-to-value (LTV) ratio and loan term, earned equity after four years now totals 8 percent, about enough to cover the cost of selling the home and not nearly enough to protect the FHA from substantial claim payments. In terms of mortgage debt capacity, today the FHA considers a 29 percent housing debt ratio normal, with 41 percent acceptable if a borrower has no other debt,[11] yet even these levels are routinely exceeded.

While the FHA utilized all forms of leverage over the period of 1954 to 2012, data are only available to track the progress of growing asset and income leverage for 1954 to 1966, picking up again in the "00" years.

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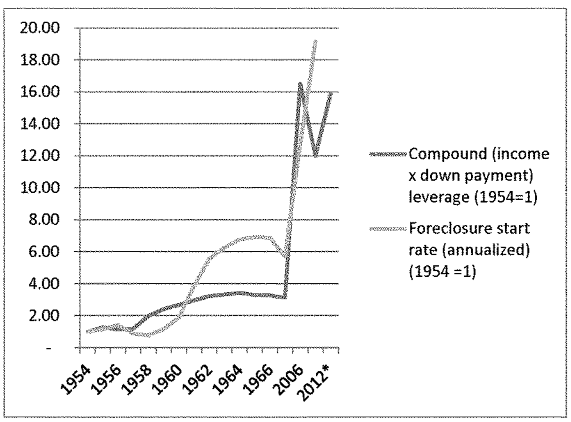
[10] In 1957, the Mortgage Guaranty Insurance Corporation was founded, the first private mortgage insurer to operate in over 20 years. The FHA's immediate response to competition was to move out the risk curve—by 1959, its average down payment had declined to 10 percent and its average term had extended to 27 years. See Herzog, *History of Mortgage Finance*.

[11] US Department of Housing and Urban Development, *The HUD Home Buying Guide*, August 2004, http://portal.hud.gov/hudportal/documents/huddoc?id=DOC_12163.pdf.

- Asset leverage increased by a factor of 5 as the average down payment declined from 20 percent to 4 percent.
- Household income leverage increased by a factor of nearly 3.5 as:
  - The average loan term increased from 21 years to 30 years, expanding buying power by about 12 percent.
  - The average housing debt ratio increased from 15 percent to 35 percent, expanding buying power by 133 percent.
  - Interest rates declined. The above comparisons are all based on a constant interest rate of 6 percent. Today, interest rates are about 3 percent, or half this rate, allowing buying power to increase by a further 30 percent.

With asset and household income leverage compounding each other, as figure 1 demonstrates, from 1954 to 2012 the average leverage on an FHA loan increased by a factor of 17 while the FHA's foreclosure start rate increased by a factor of 19. Foreclosure starts were elevated even during the boom years of the 1990s and 2000s. Today, 1 in 20 FHA borrowers enters foreclosure every year.

Figure 1. The FHA's Growing Leverage Spurs a Burgeoning Foreclosure Rate



* In calculating leverage factors for 1954–67, 2006, and 2012, interest rates were assumed to be a constant 6 percent for each year. Leverage was calculated a second time for 2012 using the current rate of 3 percent.

Sources: Mortgage Bankers Association's National Delinquency Survey and Peter J. Elmer and Steven A. Seelig, "The Rising Long-Term Trend of Single-Family Mortgage Foreclosure Rates," 1998, FDIC Working Paper 98-2, http://167.176.17.84/bank/analytical/working/98-2.pdf (foreclosure start rate data); Herzog and Earley, *Home Mortgage Delinquency and Foreclosure* (1954–67 leverage factors) and FHA Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2011, October 12, 2011, http://portal.hud.gov/hudportal/HUD?mode=dispcontent&id=HSG_ACTRMENU_10941&type=HUDGOV_HTML&rsm=Latest&width=664 (2006 and 2012 leverage factors).

The FHA's excessive use of compound leverage led to borrower and the FHA's increased dependence on unearned equity (equity accruing from house price appreciation as a result of leverage), rather than earned equity and responsible lending. Leverage is a double-edged sword. It creates a windfall of unearned equity for home buyers and reduced losses for the FHA when home prices are increasing rapidly. When prices rise more slowly or decline or when income drops, it exposes home buyers to foreclosure. Add in refinances to lower the rate and taking cash out, and burning one's mortgage by age 60 or 65 became a distant memory.

As shown in figure 1, the FHA began expanding compound leverage in 1957, followed four years later by a burgeoning foreclosure start rate. By 1962, mounting foreclosures had caught the attention of *Time* magazine:[12]

Homeowners of a new and unattractive breed are plaguing the Federal Housing Administration these days. Known as "the walkaways," they are people who find themselves unable to meet their mortgage payments—and to solve the problem simply move out their belongings at night, drop their house key in the mailbox and disappear.

The risks that the FHA's policies present to borrowers, lenders, and the market should come as no surprise. As far back as 1970, a multidecade study on postwar lending trends and their impact on mortgage delinquency and foreclosure noted the risks posed by reduced down payments, longer loan terms, high debt ratios, and cash-out refinances. The study made numerous prescient observations, including

> There have been numerous warnings that continued liberalization of mortgage terms was creating riskier loans. . . . A second effect of liberalized terms is to magnify the borrower's resources. . . . If lenders were to throw all caution to the winds and require little or no equity buildup on a property which is declining in value, defaults would almost certainly ensue.[13]

The point about magnifying a borrower's resources is particularly pertinent to today's artificially low interest rate environment provided by the Federal Reserve. The Fed's purpose is precisely that—"to magnify the borrower's resources." This poses potential risk to families, particularly low- and moderate-income ones; their communities; and the FHA itself. A family with an income of $30,000 taking out a loan with a 4 percent down payment and a 32 percent housing debt ratio is able to purchase a $110,000 home at an interest rate of 6 percent. At today's rate of 3 percent, the same borrower is able to buy a home for $146,000. This additional buying power is being built into home sale prices. If rates were to return to a still historically low 6 percent, this same family (and others like it) would see its buying power return to $110,000, a decline of nearly 25 percent. The seeds of the next crisis are being sown by the FHA (and the Fed) today.

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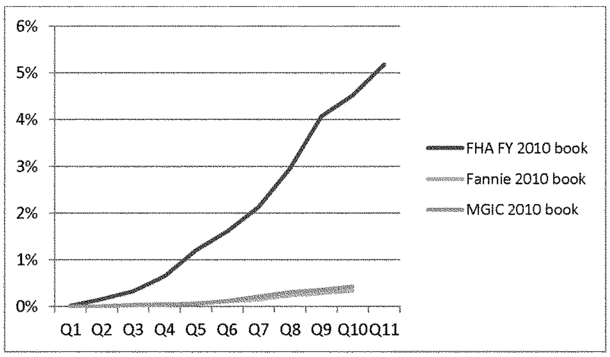
[12] "Credit: Beware of the Walkaways," *Time*, July 27, 1962, www.time.com/time/magazine/article/0,9171,827500,00.html.
[13] Herzog and Earley, *Home Mortgage Delinquency and Foreclosure*, 67–68, 50.

The FHA Today

Today, the FHA has 7.7 million loans outstanding and pays 12,000 claims per month, as opposed to the 5,000 it paid over its first 20 years of existence. Two of its more recent books are experiencing serious delinquency rates that are 8 (FY 2009 book) and 11 (FY 2010 book) times those of the Mortgage Guaranty Insurance Corporation's (MGIC's) 2009 and 2010 books of privately insured loans, respectively.[14]

Figure 2 shows continuing growth in the serious delinquency rate for the FHA's FY 2010 book compared to Fannie Mae and MGIC's rates, which have tapered off.

Figure 2. FHA, Fannie, and MGIC's 2010 Books: Serious Delinquency Trends



Note: Number of elapsed quarters since the beginning of FY 2010. There have been only 10 elapsed quarters for calendar year 2010.

Sources: FHA Single-Family Mutual Mortgage Insurance Fund Programs Quarterly Report to Congress FY 2012 Q3, miscellaneous Fannie Mae Credit Supplements, and miscellaneous MGIC Portfolio Supplements.

As a result, the following description of the FHA of the 1960s and 1970s applies to the FHA today: "Frequently working with local Realtors, [FHA] lenders would solicit home purchases from families who could not, in fact, afford the acquisition."[15]

The FHA's flawed policies in the 1960s and 1970s[16] were the impetus for much legislation over the years: the Home Mortgage Disclosure Act of 1975, the Community Reinvestment Act of 1977, and the Federal Housing Enterprises Financial Safety and Soundness Act 1992 (the GSE Act), to name but a few. These were largely aimed at the conventional market, not at reforming the FHA.

[14] Since the FHA's and MGIC's books of business are reported on a fiscal- and calendar-year basis respectively, FHA delinquency data was lagged by one quarter so that cumulative seasoning is the same.

[15] Gregory Squires, ed., *Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions* (Philadelphia: Temple University Press, 2003), 4.

[16] Ibid. Also see Brian D. Boyer, *Cities Destroyed For Cash: The FHA Scandal at HUD* (Chicago: Follett, 1973)

The problems caused by the FHA did not abate in the 1990s. Gail Cincotta, a longtime community activist critic of the FHA had this to say in 1998:

> We have been fighting abuse, fraud, and neglect of the FHA program that has destroyed too many neighborhoods and too many families' dreams of homeownership for more than 25 years. . . . The FHA program has a national default rate 3 to 4 times the conventional market, and in many urban neighborhoods it routinely exceeds 10 times. In addition, the FHA program is hemorrhaging money.[17]

As a result of the Community Reinvestment Act, the GSE Act, HUD, FHA, and other policy and program initiatives, trillions of dollars of private-sector capital were directed into financing low- and moderate-income housing. The resulting housing boom and bust repeated the FHA's earlier failure: once again harming the very families and communities these policies were intended to help.

Much legislation has also been enacted in an attempt to address deceptive, abusive, and predatory lending: the Home Ownership and Equity Protection Act of 1994 and the Dodd-Frank Act of 2009, to name two. Predatory lending was viewed as "exerting the same adverse impact on urban communities as the FHA scandals did in the 1960s and 1970s."[18] Once again, this legislation was aimed at the conventional market and ignored the FHA. So now we have come full circle, with the FHA acting as the primary source of lending in many communities and again setting up for failure the very families and communities it is tasked with helping.

Some would argue that the FHA saved the housing market because without it, the market would have collapsed.[19] Beyond the fact of the FHA's decades-long role as the home lending leverage leader, this statement also sets up a false choice. Many could agree that the FHA has played a countercyclical role, but the real choice is between responsible and irresponsible underwriting polices targeted at low- and moderate-income families.

Consider the last four years:

- The lowest home prices since 2002 in nominal prices and 1997 in real prices.
- The lowest interest rates in generations.
- Affordability at an historic high.

Had the FHA made two changes to its underwriting and program policies, the result would have been materially improved outcomes for low- and moderate-income families and communities, and the FHA itself:

- On rate and term refinances, use the benefit of a lower rate to shorten loan term and speed equity buildup.

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[17] Gale Cincotta, Statement before the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee, April 1, 1998, http://archives.financialservices.house.gov/banking/4198cinc.shtml.
[18] Squires, *Organizing Access to Capital*.
[19] John Griffith, "The Federal Housing Administration Saved the Housing Market," Center for American Progress, October 2012, www.americanprogress.org/wp-content/uploads/2012/10/Griffith_FHA.pdf.

- On home purchase loans, offer buyers either a lower down payment or a 30-year loan term, but not both—this reduction in risk layering would greatly enhance equity buildup.

Instead, the FHA's underwriting policies and practices have knowingly placed a high percentage of low- and moderate-income families and communities at risk of excessively high foreclosure rates. This study identified 9,000 zip codes with a median family income below the applicable metro area median, where the zips also have a projected foreclosure rate[20] equal to or greater than 10 percent. These high foreclosure rate zips account for 44 percent of all FHA loans that are in the low- and moderate-income zips, and they have an average projected foreclosure rate of 15 percent.

The FHA's 2011 Actuarial Study projects that 9.6 percent, or 330,000, of the 3.45 million loans it insured during FY 2009 and 2010 will ultimately be foreclosed upon or otherwise result in a claim against FHA's insurance fund.[21] With an annual foreclosure start rate 19 times the rate in 1954 and a loss severity rate 7 times the level over its first 20 years, this is not your great-grandmother's FHA.

The Government's Subprime Lender

As I have described and shown in figure 1, starting in the late-1950s the FHA began to encourage higher-risk lending. Today, the FHA operates as the government's subprime lender. To be clear, the FHA's loans are subprime because of their credit attributes—for example, borrowers with impaired credit (a FICO score below 660) or a total debt ratio of 50 percent or greater. These high-risk attributes are then generally layered with the additional risks related to a low down payment and a slowly amortizing 30-year loan term.

HUD has historically defined subprime by loan rate (self-serving, since government subsidies allow FHA mortgage rates to be at or below prime loan rates) or by the use of an identified abusive product like a 2/28 adjustable rate mortgage (ARM). However, federal banking regulators define subprime by credit characteristics—typically, borrowers with weakened or

[20] The FHA uses the term "cumulative claim rate" (CCR) to describe the cumulative rate of foreclosures, short sales, deeds-in-lieu of foreclosure, or other actions resulting in the payment of a claim on its insurance over the life of a given book of insured loans. In this paper, the terms "projected foreclosure rate" or "foreclosure rate" will be used.

[21] Projected cumulative claim rates (CCRs) for the FY 2009 and 2010 book years were estimated at 11.45 and 7.80 percent, respectively, resulting in a weighted average of 9.6 percent. The CCRs for fixed-rate 30-year mortgages were used so as to exclude streamline refinances (FHA-to-FHA refinances) pertaining to loans made in earlier years. See Appendix G-7 in US Department of Housing and Urban Development, *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2011* (excludes HECM) (Washington, DC: Author, October 12, 2011). On November 16, 2012, HUD released the *Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012* (excludes HECM) (Washington, DC: Author, October 12, 2011). This review updated the projected CCRs for FY 2009 and 2010 to 11.89 percent (up 0.45 percent from 11.45 percent in the FY 2011 Review) and 7.29 percent (down 0.51 percent from 7.80 percent in the FY 2011 Review). Since these changes effectively cancelled each other out, no change was made to the CCRs from the FY 2011 Review used for the study. The weighted average CCR of 9.6 percent for FY 2009 and 2010 as noted above is equal to the FHA's average CCR over the period 1982–2003.

incomplete credit histories or reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria. Two specific attributes relevant to the FHA are a FICO score below 660 and a total debt ratio equal to or greater than 50 percent.[22]

Today, 40 percent of the FHA's business consists of loans with either one or two subprime attributes—a FICO score below 660 or a debt ratio greater than or equal to 50 percent (loans insured during FY 2012):[23]

- 24 percent had a FICO score <660 and a debt ratio <50 percent
- 4 percent had a FICO score <660 and a debt ratio ≥50 percent
- 12 percent had a debt ratio ≥50 percent and a FICO score >660

These attributes are generally combined with a high LTV ratio (81 percent of the FY Quarter 1:2012 loans have an LTV ratio equal to or greater than 95 percent) and a slowly amortizing loan term (an estimated 90 percent have a loan term of 30 years).

For the FHA to knowingly place a high percentage of low- and moderate-income families and communities at risk of excessively high foreclosure and delinquency rates is unfair and deceptive and constitutes an abusive practice.

The FHA's Mission

Historically, the FHA's mission was to be "a targeted provider of mortgage credit for low- and moderate-income Americans and first-time home buyers."[24] As noted in their 2011 report to Congress, the Departments of Treasury and Housing and Urban Development recommended that "FHA should return to [this] . . . pre-crisis role."[25]

Democrats and Republicans alike can agree on this mission going forward. They should also agree with the benchmark HUD itself set for evaluating the FHA's performance: "Given FHA's mission, allowing the continuation of practices that result in . . . a high proportion of families losing their homes represents a disservice to American families and communities."[26]

Does the FHA meet this standard with respect to its mission of being a targeted provider of responsible mortgage credit that leads to homeownership success for low- and moderate-income Americans and first-time home buyers? Based an analysis of the FHA's FY 2009 and 2010 books of business, the answer is no.

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[22] Office of Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, 2001, www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-6a.pdf.

[23] HUD confirmed in a private email that 39 percent of its loans in FY 2012 had a FICO score of less than 660, a debt ratio greater than 50 percent, or both.

[24] US Department of the Treasury and US Department of Housing and Urban Development, *Reforming America's Housing Finance Market: A Report to Congress*, February 2011, www.treasury.gov/initiatives/documents/reforming%20america%27s%20housing%20finance%20market.pdf.

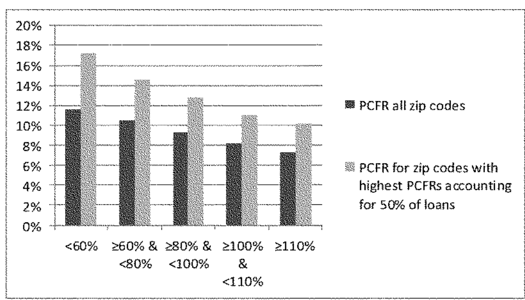
[25] Ibid.

[26] US Housing and Urban Development Department, "Federal Housing Administration Risk Management Initiatives: Reduction of Seller Concessions and New Loan-to-Value and Credit Score Requirements" (notice of proposed rulemaking), July 15, 2010, www.federalregister.gov/articles/2010/07/15/2010-17326/federal-housing-administration-risk-management-initiatives-reduction-of-seller-concessions-and-new#p-31.

The FHA's underwriting policies encourage low- and moderate-income families with low credit scores[27] to make a risky financing decision—one combining a low score with a 30-year loan term and a low down payment. This sets up for failure the very families and communities it is the FHA's mission to help. As a result, too many low- and moderate-income borrowers see their hope for the American dream turned into a nightmare.

Figure 3 shows that as a zip's median income declines in relation to the area median, the projected foreclosure rate increases (blue bars) and increases even more for the 50 percent of zips that are the most risky (red bars). For the riskiest zips with median income of less than 60 percent of the area median (red bar), the average projected foreclosure rate is over 17 percent. Yet this average masks shocking levels of failure in individual zip codes. In Chicago and Atlanta, the five zip codes with the highest projected foreclosure levels ranged from 35 to 73 percent and 24 to 30 percent, respectively. Contrast this to the five zips in Chicago and Atlanta with the lowest projected foreclosure levels. These ranged from 0 to 4 percent and 2 to 4 percent, respectively.

Figure 3. Projected Cumulative Foreclosure Rate (PCFR) by Percent of Median Area Income (FY 2009–10)



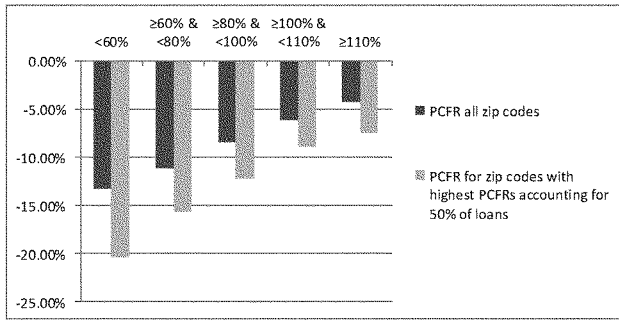
Source: Author's data.

The FHA's low- and moderate-income families in zips where the median income is below the applicable metro area median also suffered substantially larger home price declines than in zips above the area median income. For example, zips with less than 60 percent of the median income had a 13.3 percent home price decline; the average zip had a 9.4 percent decline (FHA loans), while the average decline across the United States (all homes) was 7.2 percent.

As figure 4 demonstrates, many of these families are substantially underwater on their mortgages. Even if these families do not lose their homes to foreclosure, they are unlikely to have the opportunity to accumulate equity for many years.

[27] See footnote 3.

Figure 4. Home Price Decline, June 2009–August 2012 by Zip Income as a Percent of Area Median (FY 2009-2010)



Source: Author's data.

Some might argue that an expected foreclosure rate of 10, 20, or even 30 percent is a small price to pay, as it means that 90, 80, or 70 percent of the loans are performing. Angelo Mozilo espoused this view in 2003:

> From my point of view, if 80% of the sub-prime borrowers are managing to make ends meet and make the mortgage payments on time, then, shouldn't we as a Nation, be justifiably proud that we are dramatically increasing homeownership opportunities for those who have been traditionally left behind.[28]

But strong reasons exist to dismiss the view that these levels of foreclosure are acceptable.

The collateral impact on neighbors and the surrounding community these foreclosure levels cause is substantial. These foreclosures are concentrated in low- and moderate-income neighborhoods. The resulting reduced or declining home values impact FHA and non-FHA low- and moderate-income families diligently making their payments. These families may be denied the opportunity to build equity, provide security for their family, and have the down payment for their next home as their family grows.

Foreclosures result in increased blight and crime, and the larger community suffers from a reduced tax base and higher costs for providing municipal services.

The impact of abusive lending on borrowers extends beyond excessive foreclosures. For every FHA borrower in foreclosure, another four are at an earlier stage of delinquency. Table 1a shows the impact of financial duress on FICO scores. A consumer with a 680 FICO score who

[28] Angelo Mozilo, "The American Dream of Homeownership: From Cliché to Mission," John T. Dunlop Lecture, Joint Center of Housing Studies, Harvard University, February 4, 2003, www.jchs.harvard.edu/sites/jchs.harvard.edu/files/m03-1_mozilo.pdf.

experiences a new 30-day mortgage delinquency will see his or her score drop by an average of 60-80 points.[29]

Table 1a. Impact of Financial Distress on FICO Scores

Mortgage Delinquency Impact To FICO® Score FICO

	Consumer A	Consumer B	Consumer C
Starting FICO Score	~680	~720	~780
FICO® Score after these events:			
30 days late on mortgage	600-620	630-650	670-690
90 days late on mortgage	600-620	610-630	650-670
Short sale / deed-in-lieu / settlement (no deficiency balance)	610-630	605-625	655-675
Short sale (with deficiency balance)	575-595	570-590	620-640
Foreclosure	575-595	570-590	620-640
Bankruptcy	530-550	525-545	540-560

Source: FICO® Banking Analytics Blog. ©2011 Fair Isaac Corporation

This impact on families is troubling because the FHA's abusive lending practices lead to excessive levels of delinquency. Today, one in six FHA loans is delinquent 30 days or more.

- At a projected foreclosure rate averaging 10 percent, nearly 1 in 5 FHA loans is delinquent 30 days or more at least once in a two year period.
- In a working class neighborhood with a projected foreclosure rate averaging 17 percent, nearly 1 in 3 FHA loans is delinquent 30 days or more at least once in a two year period.

Table 1b shows the estimated time for FICO Score to fully recover from a delinquency or other adverse credit event. It takes 9 months for a consumer with a 680 FICO score who experiences a new 30-day mortgage delinquency to get recover back to a 680 score (assuming no other changes).[30]

[29] http://www.philadelphiafed.org/community-development/events/2011/impact-of-workout-options-on-credit-reports-and-scores/frbp-fico-impacts.pdf
[30] Ibid.

Table 1b. Estimated time for FICO Score to fully recover

Estimated Time For FICO® Score To Fully Recover FICO

	Consumer A	Consumer B	Consumer C
Starting FICO Score	~680	~720	~780
FICO® Score after these events:			
30 days late on mortgage	~9 months	~2.5 years	~3 years
90 days late on mortgage	~9 months	~3 years	~7 years
Short sale / deed-in-lieu / settlement (no deficiency balance)	~3 years	~7 years	~7 years
Short sale (with deficiency balance)	~3 years	~7 years	~7 years
Foreclosure	~3 years	~7 years	~7 years
Bankruptcy	~5 years	~7-10 years	~7-10 years

Source: FICO® Banking Analytics Blog. ©2011 Fair Isaac Corporation

The FHA financing path keeps families in a cycle of delinquency, foreclosure, and dependency.

This abusive practice is all the more unfair and deceptive since, as I will explain more extensively below, the FHA does not price for risk. As a result, unsuspecting borrowers are offered government financing where a high-risk FHA loan is as much as 24 times more likely to experience a serious delinquency than a low-risk one.

Even if one were to take the extreme position that a failure rate in excess of 10 percent and the adverse neighborhood impacts are acceptable, there would appear to be no justification for denying prospective borrowers the facts they need to make an informed decision about the deleterious impacts of a higher-risk FHA loan.

A one-in-five chance of losing one's home and entire investment, along with being denied access to most forms of credit for three to five years and, likely, restrictions on the ability to rent a new place to live.

Even if a borrower avoids the 20 percent chance of foreclosure, he or she is substantially likely to experience a mortgage delinquency that will negatively impact his or her FICO score for years, severely limit access to credit, and greatly increase the cost of whatever credit might be available.

Equally troubling is that the FHA projects that by 2015 its median FICO score will decline from 700 to 685. Unless the FHA takes steps to reduce risk layering as it moves out the credit risk curve, its lending standards represent an even greater disservice to low- and moderate-income families and communities.

These results collectively demonstrate that the FHA is financing failure in working-class communities on a level that is a national scandal.

Credit Scores as an Objective Means of Evaluating Credit Risk

In 2007, the Federal Reserve submitted a comprehensive report to Congress on credit scores.[31] The Fed broadly concluded:

> (1) The credit history scores evaluated here are predictive of credit risk for the population as a whole and for all major demographic groups. That is, over any credit-score range, the higher (better) the credit score, the lower the observed incidence of default. These conclusions are limited to credit history scores, that is, scores calculated exclusively on the basis of individuals' credit records as assembled by the three national credit-reporting agencies (Equifax, Experian, and TransUnion). Other kinds of credit scores were not studied here.
>
> (2) Results obtained with the model estimated especially for this study suggest that the credit characteristics included in credit history scoring models do not serve as substitutes, or proxies, for race, ethnicity, or sex.
>
> (3) Different demographic groups have substantially different credit scores, on average. For example, on average, blacks and Hispanics have lower credit scores than non-Hispanic whites and Asians, and individuals younger than age 30 have lower credit scores than older individuals.

Table 2 is derived from the Federal Reserve study and quantifies the Fed's observation regarding different credit scores for different demographic groups.

Table 2. Credit Score Distribution by Demographic Groups

	Fed study interest rate	Fed study credit score distribution	Fed study default rate	FHA serious delinquency rate	Non-Hispanic white	Black	Hispanic
Credit score band							
<580	9.56%	11%	30%	30%	8%	33%	17%
580-619	8.94%	8.50%	18%	20%	7%	20%	13%
620-659	7.30%	10.50%	14%	11%	9%	15%	16%
660-719	6.40%	19%	5%	2%	20%	17%	24%
>719	6.10%	51%	1%		55%	16%	30%
Some results interpolated to standardize across credit score bands							

Source: Federal Reserve, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, May 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf.

[31] Federal Reserve, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, May 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf.

The study also found:

> Credit scoring likely increases the consistency and objectivity of credit evaluation and thus may help diminish the possibility that credit decisions will be influenced by personal characteristics or other factors prohibited by law, including race or ethnicity.
>
> The analysis conducted for this study finds that credit scores consistently predict relative loan performance within all population groups; that is, for all populations, the percentage of individuals experiencing a serious delinquency on one or more of their credit accounts consistently declines as credit scores increase. The analysis also finds that some groups perform worse (experience higher rates of serious delinquency) on their credit accounts, on average, than would be predicted by the performance of individuals in the broader population with similar credit scores. For example, on average, blacks perform worse than other racial and ethnic groups with similar credit scores. Similarly, single individuals and those residing in predominantly black or low-income census tracts perform worse on their loans than do their complementary demographic groups with similar credit scores.[32]

Financing Failure: Homing in on the FHA's Problems

The FHA Does Not Price for Risk

Two examples demonstrate this:

- The FHA charges virtually the same mortgage insurance premium for a borrower with a 3.5 percent down payment, a 580 FICO score, and a 50 percent total-debt-to-income ratio (loan A in table 2 below) as for one with a 20 percent down payment and a 720+ FICO score and a 25 percent total-debt-to-income ratio (loan G below).[33] Yet the first loan will experience a serious delinquency rate 24 times higher than the second.
- The FHA charges the same mortgage insurance premium for a borrower with a 3.5 percent down payment, a 580 FICO score, and a 50 percent total-debt-to-income ratio (loan A in table 2 below) as the same down payment and total-debt-to-income ratio, but with a 720+ FICO score (loan F below). Yet the first loan will experience a serious delinquency rate eight times higher than the second.

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[32] Ibid.

[33] The upfront premium is the same for both loans (1.75 percent). The annual premium is 1.35 percent and 1.30 percent for loans A and G, respectively. On a present-value basis, this is an inconsequential difference.

Table 3. Regardless of the Risk, the Mortgage Insurance Premium Is Essentially the Same

	Loan A	Loan B	Loan C	Loan D	Loan E	Loan F	Loan G
Term	30-yr	30-yr	30-yr	30-yr	30-yr	30-yr	30-yr
LTV	96.50%	96.50%	96.5%	96.5%	96.5%	96.5%	80%
FICO	580-599	600-619	620-659	660-679	680-719	720+	720+
Total debt-income-ratio	>50%	>50%	>50%	>50%	>50%	>50%	<=25%
Serious delinquency rate	24%	21%	14%	8%	6%	3%	1%
Mortgage insurance premium	1.75% upfront 1.35% annually	Same	Same	Same	Same	Same	1.75% upfront 1.30% annually

Source: Author.

When pricing is risk based, a higher rate signals to the borrower that his or her risk profile is higher. Flat pricing by the government encourages adverse selection, promotes moral hazard, distorts market competition, and leads to higher levels of foreclosure that impose personal as well as social costs.

Adverse selection. The Federal Reserve, in its *Report to Congress on Credit Scoring*, found:

> When the interest rate charged by a lender is appropriate for the average risk pool of prospective borrowers but is either to low or too high for some of the individual borrowers, the pool can suffer adverse selection, that is, a rise in the relative number of high risk borrowers.[34]

High-risk borrowers have incentives to take on more risk. The Federal Reserve also observed:

> High risk borrowers—those for whom the correct *individual* interest rate would be higher than the *average* rate—will perceive the single-rate offer as a good deal and accept the terms, perhaps borrowing more than they would if charged a rate more consistent with their risk profile.[35]

Stronger borrowers have incentives to take on more risk. If borrowers with good credit can make a smaller down payment or take out a larger loan relative to their income without having to pay higher mortgage insurance premiums or a higher rate, they will. This is demonstrated on home purchase loans where the FHA's minimum down payment is 3.5 percent and the average

[34] Federal Reserve, *Report to the Congress*.
[35] Ibid.

is 4 percent.[36] Those borrowers now have a higher likelihood of default than less-leveraged borrowers. They benefit from the private gains benefits accruing from rising home prices and are able to socialize their losses arising from defaults, with the risk being borne by the federal government. This results in moral hazard and attendant unintended consequences.

High-risk behavior is promoted with subsidies. Borrowers have little incentive to exercise discipline to save for a down payment, improve their credit profile, or keep debt levels moderate, since these actions do not result in a lower mortgage insurance premium or interest rate. Instead, borrowers are motivated to take on more risk through subsidies. The combined FHA/Ginnie Mae subsidy on an FHA loan may be estimated by comparing pricing for a similar Fannie Mae loan with private mortgage insurance.[37]

- *High-risk loan:* A $100,000 FHA loan with a 30-year term, a 3.5 percent down payment, and a FICO score between 620 and 639 benefits from a subsidy of $5,250 compared to a similar Fannie loan.

  About one-third of this subsidy results from the pricing advantage Ginnie Mae provides when an FHA loan is securitized.

  The rest results from the various subsidies and cross-subsidies that the FHA itself receives or creates.

  The FHA's ability to cross-subsidize high-risk loans like this one with premium income from lower-risk loans (generally those with FICO scores above 700) enables it to mask the concentrated pain inflicted on low- and moderate-income families and communities. It also enables the FHA to absorb catastrophic losses in low- and moderate-income communities.

  At the same time, the FHA's so-called lower-risk loans seem that way only when compared to its higher-risk loans. While these are the loans providing the previously mentioned cross-subsidy, they themselves are high-risk loans when compared to low-down-payment, privately insured conventional loans. The serious delinquency rate on the portion of the FHA's FY 2010 book with an LTV ratio greater than 85 percent and less than or equal to 95 percent, combined with a FICO score greater than 720, was nearly four times the rate on MGIC's entire 2010 book with similar seasoning. For example, FHA loans with a balance of $500,000–625,000 and a debt ratio greater than or equal to 50 percent had a serious delinquency rate of 9.4 percent compared to 3.8 percent on loans with a 30–40 percent debt ratio.

  Unless you are a real estate agent, it makes no sense from a policy perspective for the government to subsidize this much debt on $500,000-plus loans when the solution is

[36] US Department of Housing and Urban Development, *Quarterly Report to Congress on FHA Single-Family Mutual Mortgage Insurance Fund Programs*, Quarter 3, 2012, Exhibit A-7, http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/rtc/fhartcqtrly.

[37] A Fannie loan with private mortgage insurance incorporates a substantial degree of risk-based pricing. However, it is widely recognized that it is still below market-based pricing because of inadequate capital levels and return thereon.

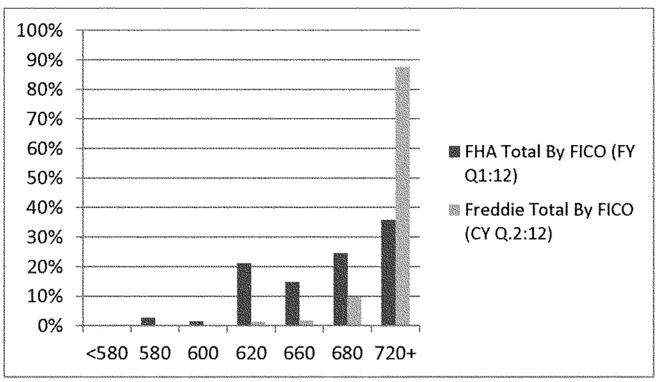
for buyers to purchase a somewhat less-expensive home.

- *Medium-risk loan:* A $100,000 FHA loan with a 30-year term, a 5 percent down payment, and a FICO score between 700 and 719 benefits from a subsidy of $1,695 compared to a similar Fannie loan.

Housing finance participants that price for risk cannot compete with government programs that do not. Today, the FHA and the other agencies[38] using the Ginnie Mae guarantee account for about half of all home purchase loans. The failure to price for risk, along with other advantages the government bestows on the agencies, crowds out competitors since they do price for risk. This can be seen by comparing FHA FY Quarter 1:2012 and Freddie Mac CY Quarter 2:2012 loans:[39]

Figure 5 shows there is little FICO credit score overlap, given 65 percent versus 13 percent of the FHA and Freddie's volumes, respectively, have credit scores below 720.

Figure 5. FHA's Subsidy and Underwriting Advantages Crowd Out Freddie Mac

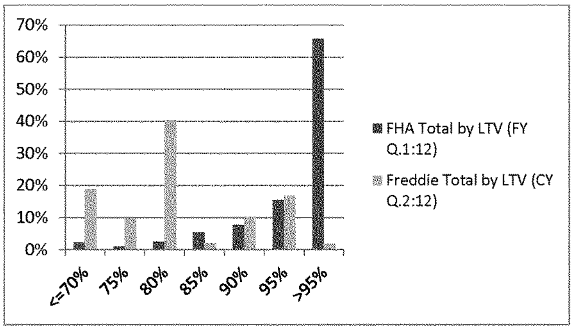


Source: Inside Mortgage Finance and this study.

Figure 6 demonstrates there is also little LTV ratio overlap given that 81 percent versus 19 percent of the FHA and Freddie's volumes, respectively, have an LTV ratio of 95 percent or greater.

[38] The FHA, the USDA, and the VA are called "agencies" since they are agencies of the federal government.
[39] Freddie loan-level detail file from Inside Mortgage Finance. There are minimal distribution differences between FY Quarter 1:12 FHA volume and CY Quarter 2:12 Freddie volume.

Figure 6. FHA's Subsidy Advantages Crowd Out Freddie Mac



Source: Inside Mortgage Finance and this study.

Higher levels of foreclosure have an adverse impact on neighborhoods. Abundant research documents the adverse impacts on neighborhoods, including reducing neighboring property values,[40] higher levels of crime,[41] impact on children,[42] older citizens,[43] and an adverse impact on health,[44] and a disproportionate impact on minorities.[45]

With respect to the direct adverse impact of foreclosures on nearby families, the Center for Responsible Lending found: "On average, families affected by nearby foreclosures have already lost or will lose $21,077 in household wealth, representing 7.2 percent of their home value, by virtue of being in close proximity to foreclosures. Families impacted in minority neighborhoods have lost or will lose, on average, $37,084 or 13.1 percent of their home value."[46]

[40] See W. Scott Frame, "Estimating the Effect of Mortgage Foreclosures on Nearby Property Values: A Critical Review of the Literature," Economic Review No. 3, 2010, www.frbatlanta.org/documents/pubs/economicreview/er10no3_frame.pdf; John Y. Campbell et. al., "Forced Sales and House Prices," December 2009, http://economics.mit.edu/files/3914; and Debbie Gruenstein Bocian et. al., "Collateral Damage: The Spillover Costs of Foreclosures," October 24, 2012, www.responsiblelending.org/mortgage-lending/research-analysis/collateral-damage.html.

[41] See Dan Immergluck and Geoff Smith, "The Impact of Single-family Mortgage Foreclosures on Neighborhood Crime," November 2006, www.prism.gatech.edu/~di17/HousingStudies.pdf; and Ingrid Gould Ellen et. al., "Do Foreclosures Cause Crime?" June 23, 2011, http://furmancenter.org/files/publications/Ellen_Lacoe_Sharygin_ForeclosuresCrime_June27.pdf.

[42] Philipp Lovell and Julia Isaacs, "The Impact of the Mortgage Crisis on Children, April 18, 2008, www.brookings.edu/~/media/research/files/papers/2008/5/04%20mortgage%20crisis%20isaacs/04_mortgage_crisis_isaacs.pdf; and Joanne Wood et. al., "Local Macroeconomic Trends and Hospital Admissions for Child Abuse, 2000–2009," July 16, 2012, http://pediatrics.aappublications.org/content/early/2012/07/11/peds.2011-3755.abstract?sid=aba13d57-dffc-471d-847e-5d137ec2bc9d.

[43] Lori Trawinski, Nightmare on Main Street: Older Americans and the Mortgage Market Crisis, AARP Public Policy Institute, July 2012, www.aarp.org/content/dam/aarp/research/public_policy_institute/cons_prot/2012/nightmare-on-main-street-AARP-ppi-cons-prot.pdf.

[44] See Janet Currie and Erdal Tekin, "Is the Foreclosure Crisis Making Us Sick?" NBER Working Paper No. 17310, August 2011, www.nber.org/papers/w17310.

[45] Bocian et al., "Collateral Damage."

[46] Ibid.

Conclusions:

- The FHA not pricing for risk leads to a variant of Gresham's Law: high risk lending drives out low risk lending.
- The FHA's high risk lending policies sell hope and deliver harm, making them a disservice to low- and-moderate-income families and communities.

The FHA Does Not Underwrite for Risk

Based on an analysis of the characteristics of FHA loans, it is apparent that the FHA does not adequately evaluate the various risk factors present in a loan in a holistic manner. See appendix A for additional detail on these risk relationships.

Consider the FHA's underwriting of home purchase loans:
Down Payment: While the FHA's minimum down payment on a home purchase loan is 3.5 percent, the average is 4 percent. This indicates that down payment is not being used as a factor to offset other risks present on an individual loan.

- As indicated in appendix A, LTV ratio is generally a moderately effective indicator of default for FHA loans with FICO scores below 660.

- **Loan term:** 92 percent of all fully underwritten fixed rate loans (purchase and refinance) have a 30-year term. This indicates that loan term is not used as a factor to offset other risks. As indicated in appendix A, loan term is generally a moderately effective indicator of default for FHA loans, although less so for FICO scores below 620.

Total debt ratio: A slightly higher percentage of borrowers with a 620–659 scores had a total debt ratio greater than 50 percent than did borrowers with a 720+ FICO score. This indicates that total debt ratio was not used as a factor to offset other risks present on an individual loan.

- As indicated in appendix A, total debt ratio is generally a moderately effective indicator of default for FHA loans, although its effectiveness declines as FICO score declines.

Having eliminated underwriting variation based on down payment, loan term, and total debt ratio, only FICO score remains.

- As the Federal Reserve found, "Credit scores consistently predict relative loan performance within all population groups."[47]
- The performance of FHA loans indicates that that FICO score is a strong indicator of default for FHA loans.

The FHA's underwriting policies largely ignore the fact that a 30-year term loan with a 95 percent LTV, a FICO score of 580–599, and a debt ratio of >50 percent has a serious delinquency rate of 24 percent, which is 24 times the 1 percent serious delinquency rate on a 30-year term loan with 95 percent LTV, a FICO score of >720, and a debt ratio of <25 percent.

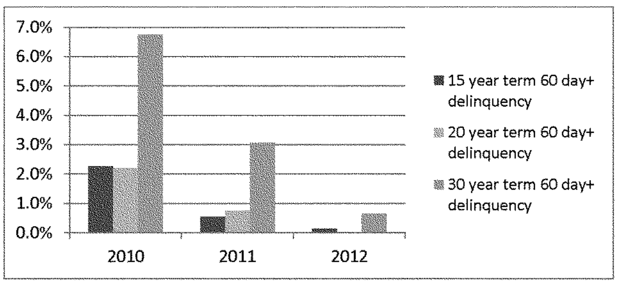
[47] Federal Reserve, *Report to the Congress*.

Likewise, it ignores that a 30-year term loan with a 95 percent LTV, a FICO score of 580–599, and a debt ratio of >50 percent has a serious delinquency rate of 24 percent, 8 times the serious delinquency level of 3 percent on a 30-year term loan with 95 percent LTV, a FICO score of >720, and a debt ratio of >50 percent.

However, a 20-year loan term can be used effectively to mitigate risk across all FICO bands.

Figure 7 compares delinquency rates for 15-, 20-, and 30-year term mortgages. Mortgages with 15- and 20-year terms perform similarly and have far lower delinquency rates than 30-year mortgages.

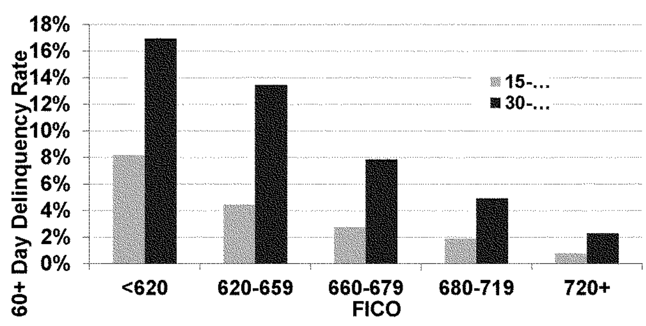
Figure 7. FHA Home Purchase Mortgage Performance by Term



Source: Author's data.

Figure 8 shows that shorter-term mortgages effectively to mitigate risk across all FICO bands. Figure 8 is limited to 15- and 30-year term mortgages as FHA's 20-year is insufficient for this level of detail.

Figure 8. FHA Home Purchase and Refinance Mortgage Performance by Loan Term across FICO Bands (60-day-plus delinquency)



Source: Author's data.

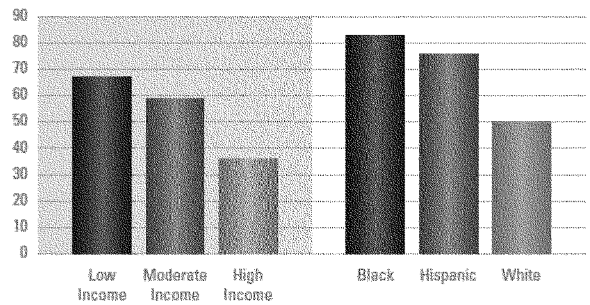
Conclusions:

- The FHA's failure to underwrite in a responsible manner leads it to largely ignore risk layering on individual loans.
- This leads to unnecessarily high foreclosure and delinquency rates that are a disservice to low- and moderate-income families and communities.
- Reducing loan term is highly effective as a risk mitigant.

The FHA's Irresponsible Underwriting Policies and Abusive Lending Practices

As shown in figure 9, a high percentage of the home purchase loans made to low- and moderate-income and minority borrowers are backed by the government.[48]

Figure 9. Share of Home Purchase Loans with Federal Backing in 2010 (Percent)



Notes: Federally backed loans include FHA/VA and USDA Rural Housing loans. Low income is defined as less than 80 percent of area median income (AMI), moderate income is 80–120 percent of AMI, and high income is above 120 percent of AMI. Black and white householders are non-Hispanic; Hispanics may be of any race.
Source: JCHS tabulations of 2010 Home Mortgage Disclosure Act data.

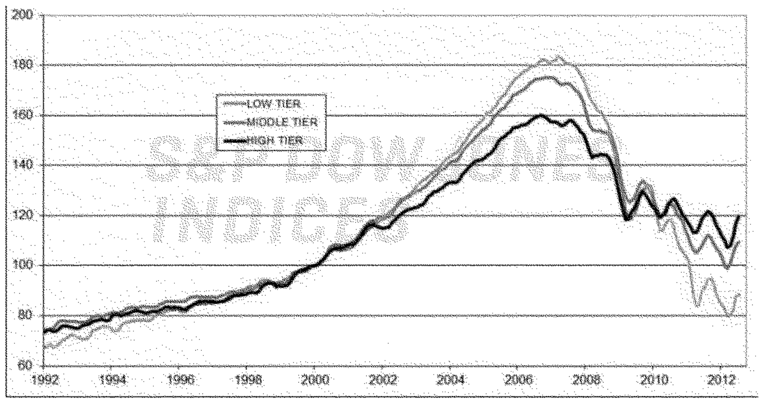
Virtually all of these loans combine a 30-year loan term with a low or no down payment, and many are to borrowers with low credit scores and/or high debt ratios. This intentional risk layering places a high percentage of low- and moderate-income families and communities at risk of excessively high foreclosure and delinquency rates. Combined with the FHA's failure to price or underwrite for risk and the fact that low-price-tier neighborhoods have historically had more volatile price movement, this policy results in disproportionate impact on low- and moderate-income families and communities. Since failing to price and underwrite for risk is done knowingly, the FHA's underwriting policies and practices are unfair and deceptive and constitute an abusive practice.

More Volatile Price Movement

More volatile home price movement for lower-price-tier homes was generally the case during the Great Boom/Bust of the 1990s/2000s. The lowest price tier had the largest percentage price increases followed by the steepest declines. Figure 10 provides a representative example:

[48] Joint Center for Housing Studies of Harvard University, *The State of the Nation's Housing—2012*, www.jchs.harvard.edu/sites/jchs.harvard.edu/files/son2012.pdf.

Figure 10. S&P/Case-Shiller Chicago Tiered Home Price Indices



Source: S&P Indices and Fiserv.

A study of 16 large metro areas found that in every case, the prices of homes in the lower price tier have fallen more from the peak than homes in the median and high price tiers.[49]

This trend has continued since mid-2009 as lower-price-tier homes insured by the FHA in FY 2009–10 have also seen greater price declines or smaller price increases than higher-priced homes.

The combination of the FHA's underwriting policies and practices and low-tier home price volatility results in a disproportionately high level of low- and moderate-income families losing their homes.

As previously noted, this study found 9,000 zip codes where the median income is below the applicable metro area median and where the projected foreclosure rate is equal to or greater than 10 percent. These zips account for 44 percent of all loans in the low- and moderate income zips. The average projected foreclosure rate for these zips is 15 percent.

However the impact extends well beyond the 10 percent or more that may lose their homes.

- Another 20 to 30 percent will have their credit scores impacted by one or more delinquent payments.
- All homeowners in the neighborhood will be impacted as these FHA loans become delinquent and go into in foreclosure.

[49] Ibid.

How the Study of the FHA's FY 2009 and 2010 Books Supports This Analysis

In this study, I undertook a detailed examination of the FY 2009 and 2010 books to identify which loans are most likely to suffer a foreclosure. I also sought to identify which zip codes will bear the brunt of the 330,000 foreclosures forecast to result from the FY 2009 and 2010 books of insurance.[50]

Data included loan risk factors such as LTV, FICO score, loan term, and debt-to-income ratio along with delinquency status. Based on delinquency data along with projections from the FHA's Actuarial Study, I calculated a projected cumulative foreclosure and other insurance claim rate ("projected cumulative foreclosure rate") for each zip code.[51] Additional demographic data was appended at the zip code level, including median family income, house price change, and percent of mortgages underwater.

An analysis of the entire database revealed that while LTV, FICO score, loan term, and debt-to-income ratio are captured as part of the insurance process, the FHA did not appear to be use these risk factors in any significant way in deciding whether to insure a given loan or under what terms.

I then analyzed the results at a zip code level within individual large metropolitan (metro) areas[52], with a particular focus on zip codes where the median family income was below the median family income for the metro area. The results were striking in that most metro areas showed an extremely wide dispersion of projected cumulative foreclosure rates, typically from a low of 3–5 percent to a high of 20–30 percent or higher across a broad range of incomes below the median for the metro area.

Further analysis was undertaken to determine what might explain this result. The study found:

1. A wide disparity in projected cumulative foreclosure rates among metro areas;

[50] The study used a database consisting of loan performance data for 2.4 million FHA loans from the FY 2009 and 2010 books, estimated to represent 70 percent of the 3.45 million loans insured by the FHA for these two book years. To be conservative, the CCR for fixed-rate 30-year mortgages was used to calculate the estimated number of foreclosures expected to result from these 3.45 million loans. FY 2009 and FY 2010 have CCRs of 11.45 percent and 7.80 percent respectively. The all mortgages rates are higher (12.98 and 8.75 percent, respectively), primarily because of the impact of streamlined refinances. CCRs are from US Department of Housing and Urban Development, *2011 Actuarial Review*, Appendix G-7.

[51] FY 2009 and FY 2010 had CCRs of 11.45 percent and 7.80 percent, respectively. A FY 2009 and FY 2010 serious delinquency rate was calculated for each zip. Each of these rates was multiplied by the applicable CCR for FY 2009 or 2010. This yielded a zip-level CCR for each fiscal year. A weighted average CCR was then calculated for each zip.

[52] Metropolitan areas are officially called Core Based Statistical Areas (CBSAs). Portions of the CBSAs of Chicago; New York; Boston; Washington, DC; Miami; Philadelphia; Detroit; Dallas-Ft. Worth; Seattle; San Francisco; and Los Angeles are further segmented into divisions. For example, the Chicago CBSA (formally named "Chicago-Naperville-Joliet, IL-IN-WI") consists of three divisions: Chicago-Joliet-Naperville, IL; Gary, IN; and Lake County-Kenosha County, IL-WI. This distinction comes into play when analyzing median family income versus median area home price. While area median family income is available at the CBSA/CBSA division level, area median home price is available for the entire CBSA only and is not further divided by division.

2. An even wider disparity among zip codes within metro areas.
3. At the metropolitan statistical area (metro area) level, FICO scores largely accounted for the wide dispersion of projected cumulative foreclosure rates among zip codes that had a median family income below the metro area median.
4. Many areas with heavy concentrations of FHA loans suffered declining home prices since mid-2009. Home price declines had a disproportionate impact on low-and moderate-income families and communities, the groups traditionally served under the FHA's mission.

Implications

These results raise serious policy issues:

1. **The lending policies that FHA has in place today promote the financing of failure for too many families and too many communities:** The study found 9,000 low- and moderate-income zip codes with projected cumulative foreclosure rates of 10 percent or greater, with an average 15 percent projected cumulate foreclosure rate. These zips accounted for 38 percent of the study's 23,800 low- and moderate-income zip codes and for 44 percent of all FHA loans studied in these same zip codes.
2. **The FHA's lending policies are putting borrowers in low- and moderate-income communities in a negative equity hole that will be difficult to escape from.** As noted in Figure 12 below families in zips where the median family income is below the applicable metro area median suffered substantially larger home price declines than those in zips above the area median.
3. **Although many agree the FHA's activity needs to be refocused on its traditional mission of serving low-income borrowers, if this occurs and the FHA continues its irresponsible lending policies, it will be financing failure on an even larger scale.** The FHA plans to continue its underwriting policies with one notable change: reducing its median FICO score from 700 to a projected score of 660. This higher level of risk-layered loans will result in a substantial increase in expected foreclosure rate. Unless reduced, we face the prospect of the FHA performing a further disservice to American families living in low- and moderate-income communities.

4. **The guarantee of the taxpayer is used to put low- and moderate-income families and communities at risk.** The FHA's pricing advantages and lending policies entice many low- and moderate-income families into loans that finance failure. The enablers of the FHA rely on this backstop to encourage, originate, securitize, and guarantee these risky loans.

What Is the Impact of the FHA's Lending Policies at the Individual Zip Code and Metropolitan Area Levels?

A review at the zip code and metropolitan area levels confirmed that risk layering, combined with high FHA loan volumes, leads to a concentration of high foreclosure and delinquency rates in low- and moderate-income communities.[53]

[53] All study results are based on the performance of loans from the FHA's FY 2009 and FY 2010 books. While the books were analyzed separately, the results are reported for the combined books on a weighted average basis. National results are based on all relevant zip codes with at least one FHA loan. Metro area map results are based

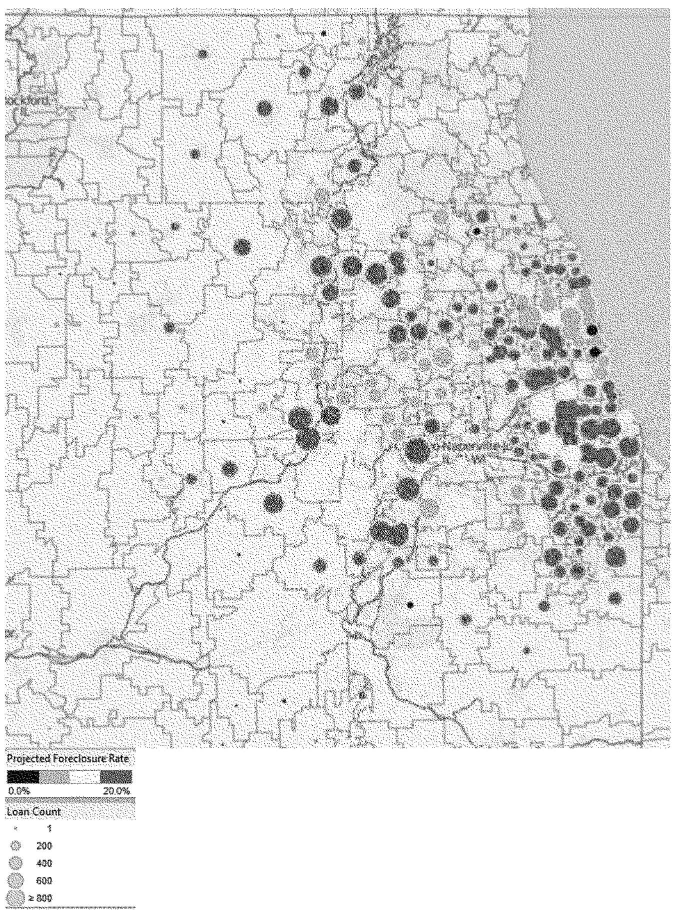
This section contains an overview of the case study for Chicago, which is generally representative of the metropolitan areas studied. The full results for Chicago and additional metropolitan areas may be found on an interactive website for my project: www.NightmareAtFHA.com.

The zip boundaries are color coded based on a scale of a projected cumulative foreclosure rate of percent for the FHA's combined FY 2009 and 2010 books.

on all relevant zip codes with at least one FHA loan. Metro area scatter plot results are based on all relevant zip codes with at least 50 FHA loans.

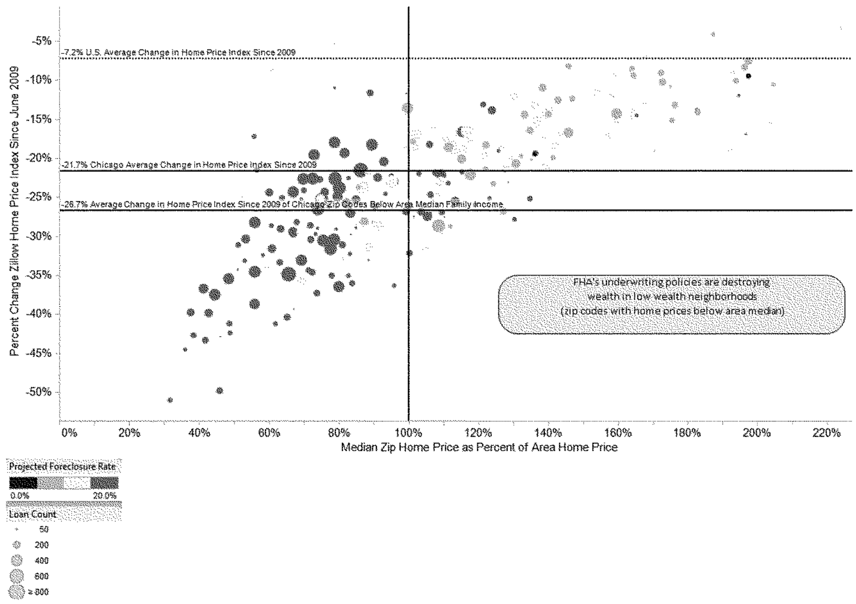
Figure 11. Chicago Metro Area: Map Showing Projected Foreclosure Rate by Zip Code and Loan Count

The summary of the Chicago study[54] begins with a metropolitan area map at the zip code level. The projected cumulative foreclosure rate is shown for each zip. The zip is represented by a dot, with the color of the dot representing a rate of 0 to <5 percent, 5 to <10 percent, 10 to <15 percent and ≥15 percent. The size of the dot represents the volume of loans insured in the FY 2009 and 2010 books.



[54] Consisting of Cook County (IL), DeKalb County (IL), DuPage County (IL), Grundy County (IL), Kane County (IL), Kendall County (IL), McHenry County (IL), and Will County (IL).

Figure 12. Chicago Metro Area: Scatter Plot Showing a Zip Code's Relationship with Respect to Relationship of Income, Home Price Declines, and Foreclosure Rates



The x-axis represents a zip code's median home price as a percent of the area's median home price.

The y-axis represents a zip code's median home price change since June 2009.

- The US median home price change was 7 percent since June 2009.
- Chicago's median home price declined 22 percent since June 2009.
- Median home prices declined 26.7 percent in those Chicago zip codes where the median family income was below the area media

The color of the dot represents the zip's foreclosure rate.

The size of the dot represents a zip's loan count of FHA loans in 2009-2010.

What this scatter plot tells us:

- Price declines were greatest in lower-income areas, which would also have had lower-priced homes. In this instance, the preponderance of zips with a median family income of less than 100 percent of the area median had price declines greater than 22 percent for the area (average was -26.7 percent for zips less than 100 percent of area median).

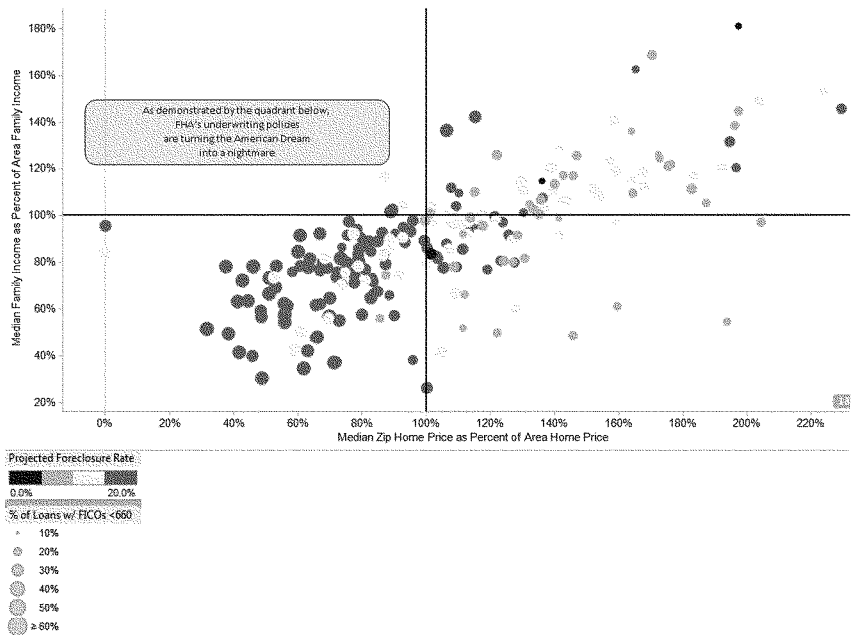
- These same zips tend to have very high expected foreclosure rates and higher-than-average loan counts.

- The lower-right portion gridded area of the scatter plot highlights the problem. Rather than helping low- and moderate-income families build meaningful equity along with stable communities, the FHA's underwriting policies are leading to equity destruction.
- Beyond the direct impact on families in terms of being likely to experience excessive foreclosure and delinquency rates, other FHA borrowers and the overall community suffer from equity destruction as a result of larger-than-average price declines.

FHA reform principles supported:

- Principle 1: Step back from markets that can be served by the private sector.
- Principle 2: Stop knowingly lending to people who cannot afford to repay their loans.
- Principle 3: Set loan terms that help homeowners establish meaningful equity in their homes with the goal of ending their dependence on FHA lending.
- Principle 4: Concentrate on those home buyers who truly need help purchasing their first home.

Figure 13. Chicago Metro Area: Scatter Plot Showing a Zip Code's Relationship with Respect to Relationship of Income, Home Prices, Low Credit Quality Borrowers, and Foreclosure Rates



The x-axis represents a zip code's median home price as a percent of the area's median home price.

The y-axis represents a zip code's median family income as a percent of the area's median family income.

The color of the dot represents a zip's foreclosure rate.

The size of the dot represents a zip's percentage of loans with a low FICO score (less than 660).

What this scatter plot tells us:

- The lower-left quadrant (representing zips with both a median family income and a median home price below Chicago's $73,000 median family income and $161,000 median home price, respectively) contains more than half of the loans.
    - The zip codes in the lower-left quadrant account for 53 percent of the loans in all the zip codes shown.
    - This quadrant showed a higher percentage of loans with a low FICO score and a high foreclosure rate.
    - Rather than providing responsible mortgage credit that leads to homeownership success for low- and moderate-income families and communities, the FHA's loans perform a disservice to the very families and communities it is tasked to serve.

FHA reform principles supported:

- Principle 1: Step back from markets that can be served by the private sector.
- Principle 2: Stop knowingly lending to people who cannot afford to repay their loans.
- Principle 3: Set loan terms that help homeowners establish meaningful equity in their homes with the goal of ending their dependence on FHA lending.
- Principle 4: Concentrate on those home buyers who truly need help purchasing their first home.

Table 4 sets forth the foreclosure rate, percent of purchase loans that were government loans[55] in 2009, and other data for the 10 Chicago zip codes with the lowest and 10 with the highest projected foreclosure rates. Each zip had at least 50 FHA loans. As I have noted, FHA and other government-backed loans are much more predominant among low- and moderate-income home buyers.

The chart demonstrates the strong correlation among foreclosure rate, FICO score, income, and home price. It also demonstrates the harmful effects of the FHA's policies that promote layered risk. This negative impact is magnified because zip codes with the highest foreclosure rates also have the highest incidence of home purchase lending guaranteed by a government agency (FHA, US Department of Veterans Affairs [VA], and US Department of Agriculture [USDA]/Rural Housing Service). This concentrates the FHA's abusive lending practices on

[55] Government loans are those insured by the FHA, US Department of Veterans Affairs, and the Rural Housing Administration of the US Department of Agriculture. Virtually all government--insured home purchase loans have a loan-to-value ratio in excess of 98 percent.

those low- and moderate-income families and communities least able to withstand the impact of high-risk lending and resulting foreclosures.

Table 4. Chicago-Joliet-Naperville: 10 Zip Codes with Lowest and Highest Projected Foreclosure Rates along with Demographic Data

Property Zip GNW	Loan Count GNW	Average CTR GNW	Percent of FICOs <660 GNW	HMDA Data: FHA, FSA/RHS & VA Loans as Percent of Total Home Purchase Loans	Median Family Income for CBSA division or CBSA (FFIEC)	Median family income ($) (census)	Median family income (zip)/median family income (CBSA/division) - derived	Aug 2012 Zillow Home Price Index	Aug 2012 CBSA ZHPI	ZHPI as % of area home price
Lowest										
60661	121	1.6%	13.2%	13.3%	$72,747	83527	115%	218,700	160,768	136%
60070	60	3.8%	40.0%	28.0%	$72,747	60866	84%	163,000	160,768	101%
60614	144	4.2%	14.6%	9.8%	$72,747	131700	181%	317,100	160,768	197%
60657	207	5.1%	12.6%	13.8%	$72,747	91886	126%	276,900	160,768	172%
60642	78	5.4%	21.8%	N/A	$72,747			281,200	160,768	175%
60463	64	5.4%	28.1%	26.5%	$72,747	91382	126%	236,000	160,768	147%
60610	148	5.4%	15.5%	13.2%	$72,747	67057	92%	179,100	160,768	111%
60607	227	5.5%	19.8%	19.2%	$72,747	58349	80%	204,200	160,768	127%
60613	223	5.6%	17.9%	16.9%	$72,747	71979	99%	227,100	160,768	141%
60187	175	5.9%	28.0%	32.6%	$72,747	77654	107%	218,000	160,768	136%

Property Zip GNW	Loan Count GNW	Average CTR GNW	Percent of FICOs <660 GNW	HMDA Data: FHA, FSA/RHS & VA Loans as Percent of Total Home Purchase Loans	Median Family Income for CBSA division or CBSA (FFIEC)	Median family income ($) (census)	Median family income (zip)/median family income (CBSA/division) - derived	Aug 2012 Zillow Home Price Index	Aug 2012 CBSA ZHPI	ZHPI as % of area home price
Highest										
60621	142	72.6%	54.2%	41.49%	$72,747	22243	31%	78,400	160,768	49%
60636	209	60.1%	56.5%	49.72%	$72,747	30278	42%	67,000	160,768	42%
60609	212	45.5%	43.9%	24.70%	$72,747	27184	37%	115,400	160,768	72%
60624	134	41.4%	59.0%	36.22%	$72,747	25265	35%	99,300	160,768	62%
60637	174	35.3%	56.3%	37.60%	$72,747	27096	37%	114,500	160,768	71%
60428	110	33.2%	59.1%	N/A	$72,747			57,700	160,768	36%
60456	66	31.7%	57.6%	70.2%	$72,747	48512	67%	82,000	160,768	51%
60827	177	31.6%	54.2%	65.4%	$72,747	36059	50%	61,600	160,768	38%
60422	137	31.6%	47.4%	60.6%	$72,747	103477	142%	185,200	160,768	115%
60426	140	30.1%	60.7%	69.6%	$72,747	37529	52%	50,800	160,768	32%

Sources: Author's data and City-Data.com.

Figure 12 above shows the strong correlation among a zip's relative home price, its home price decline since June 2009, its projected foreclosure rate, and FHA loan volume (all for the Chicago metro area). While Chicago had an average price decline of 22 percent since June 2009 (well exceeding the US average of 7 percent), the lower-left quadrant (representing zips with a median home price below Chicago's median of $161,000 and a home price decline exceeding the US average of 7 percent) generally experienced larger price declines than the Chicago median decline of 22 percent, much higher foreclosure rates, and higher levels of FHA lending.

Conclusions:

- The FHA's risk-layered approach is irresponsible.
- The approach is a disservice to the very families and communities it is its mission to serve.
- FHA's underwriting policies are unfair and deceptive and constitute an abusive lending practice. The Consumer Financial Protection Agency should determine whether the FHA's underwriting policies are unfair, deceptive, and abusive under the Dodd-Frank Act.

The Adverse Financial Impact of These Foreclosures on the Nearby Community

The FHA projects that its FY 2009 and 2010 books will result in 330,000 foreclosures.[56] This study found that an estimated 85 percent of these foreclosures will occur in zip codes with a median income below the metropolitan area median. There are two distinct, direct adverse financial impacts of these foreclosures:

First, the FHA's losses on the 280,000 foreclosures (85 percent of 330,000) equals **$20 billion** (280,000 foreclosures times an estimated $70,000 per foreclosure claim).

Second is the impact on the price of nearby homes owned by families located in these working class zip codes with high expected foreclosure rates. The methodology developed by Harding, Rosenblatt, and Yao in 2008[57] is used to estimate the loss associated with each foreclosure. They found each foreclosure results in an average estimated 1 percent home price reduction on every home within a 600 foot radius (0.04 square miles) of a foreclosure. Assuming a housing density of 2,500 homes per square mile, each foreclosure results in a 1percent home reduction on each of 100 neighboring homes. At an average home price of $133,000, the impact is $1,333 per affected home.

> The FHA's 280,000 foreclosures results in 28 million homes suffering total price depreciation of **$37 billion**.[58]
>
> The combined total of these direct impacts is **$57 billion**.

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[56] This analysis focuses solely on the FHA's FY 2009 and 2010 books using a database consisting of loan performance data for 2.4 million FHA loans from these years. This is estimated to represent 70 percent of the 3.45 million loans insured by the FHA for these two book years. To be conservative, the CCR for fixed-rate 30-year mortgages was used to calculate the estimated number of foreclosures expected to result from these 3.45 million loans. FY 2009 and FY 2010 have CCRs of 11.45 percent and 7.80 percent, respectively (weighted average of 9.6 percent). The all mortgages rates are higher (12.98 and 8.75 percent, respectively), primarily because of the impact of streamlined refinances. In terms of national impact, the MBA's delinquency data indicates that the FHA's 2003–10 books are projected to result in over 1.7 million foreclosure starts, with the preponderance almost certainly in zip codes with a median income below the metropolitan area median.

[57] John P. Harding, Eric Rosenblatt, and Vincent W. Yao, "The Contagion Effect of Foreclosed Properties," *Journal of Urban Economics*, 66, no. 3 (July 28, 2008): 164–78, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1160354.

[58] This is considered to be a low dollar estimate, as the FHA's foreclosures are concentrated geographically, and the Harding et al. research indicates that multiple foreclosures in the same vicinity magnify the price decline impact in surrounding homes.

Who Are the FHA's Enablers?

How is it that the FHA is able to continue its irresponsible and abusive lending practices targeted at low- and moderate-income families and communities?

Why is there little concern over the fact that the FHA's overall delinquency rate is habitually around one in six loans?

The FHA, as part of the Government Mortgage Complex (consisting of Fannie Mae, Freddie Mac, the FHA, the USDA, the VA, and Ginnie Mae), benefits from a web of subsidies, benefits, and mandates—all of which stem from the presence of an unlimited full faith and credit government guarantee. Mortgage-backed securities (MBS) investors, real estate agents, home builders, and bureaucrats are all able to profit from the FHA program and act as enablers precisely because of the influence they exert on Congress. Their goal is to continue these profitable, but unfair, deceptive, and abusive lending practices, notwithstanding the negative outcomes for many low- and moderate-income families and neighborhoods. The presence of a government guarantee causes Congress and regulators to be indifferent to the quality of the underlying mortgages even while expressing nominal opposition to these abusive practices.

Investors in Ginnie Mae mortgage-backed securities (Ginnie MBS) are indifferent to the quality of the underlying mortgages since Ginnie MBS are backed by the full faith and credit of the US government.

Congress and regulators are indifferent to the quality of the underlying mortgages since Ginnie MBS and FHA loans are backed by the full faith and credit of the US government. As a result Ginnie MBS are given a zero risk-based capital weighting, compared to a 20 percent weight for government-sponsored enterprises (GSE) MBS and even higher weights for home mortgages. This encourages investment by domestic and foreign bank buyers. Foreign buyers —central banks and commercial banks—hold an estimated 30 percent of outstanding Ginnie securities. Additionally, Ginnie MBS get preferential treatment when used to meet bank liquidity requirements and are exempt by law from the risk-retention requirements of the Dodd-Frank Act. Finally, banks holding FHA loans with subprime attributes are not counted as subprime, since the banks have minimal credit exposure.

Ginnie Mae is largely indifferent because it is insured against loss by the FHA, an agency backed by the full faith and credit of the US government.

Real estate agents and home builders (and the associations that represent them) are largely indifferent since they take their profits at the loan closing.

Originators continue to originate these risky loans because they are insured against loss by the FHA.[59]

Borrowers are indifferent since they are charged the same insurance premium regardless of whether it is a 30-year term loan with 96.5 percent LTV ratio, a 580 FICO credit score, and a 50 percent debt ratio or a 96.5 percent LTV ratio, a 740 FICO credit score, and a 50 percent

[59] Originators have attempted to protect themselves from excessive liability related to loan repurchase requests by imposing higher credit requirements (credit overlays) than required by the FHA. The FHA is considering a complaint charging that such credit overlays are illegal.

debt ratio. This policy leaves borrowers in the dark with respect to risk. A substantial percentage of FHA loans can be fairly characterized as irresponsible, even toxic loan products. But the FHA does not disclose these extraordinarily high levels of risk to borrowers and FHA is able to cover the outsized losses on these risky loans through the use of cross-subsidies.

The combination of not pricing or underwriting for risk and government guarantees allows all the above participants to ignore or be ignorant of the risks that result from the FHA's policies. In short, the FHA is built around moral hazard[60] where no one has real skin in the game.

Take real estate agents and home builders. They continually call for looser lending to qualify more marginal buyers.[61]

Consider the Community Reinvestment Act where layered risks are termed "flexible" underwriting standards.

Finally, this is a result that could not continue without the tacit support of Congress, the FHA's regulator.

The NAR as Enabler: Real Estate Agents Gain Even as Low- and Moderate-Income Borrowers Lose

Real estate agents get their profits at the time a home is sold, leaving them with no "skin in the game" of housing finance. Thus, it comes as no surprise that the National Association of Realtors (NAR) has a long history of promoting looser lending—meaning more marginal buyers, meaning more sales, meaning higher prices, meaning more commissions.

In a NAR news release, the organization's chief economist, Lawrence Yun predicted that a return to normal lending conditions would greatly help the US economy. According to Yun, "Sensible lending standards would permit 500,000 to 700,000 additional home sales in the coming year." [62] Yun then turned to FICO scores on denied FHA loans: "The Office of the Comptroller of the Currency has defined a prime loan as having a FICO score of 660 and above. However, the average FICO score for denied applications on FHA loans was 669 in May of this year, well above the 656 average for loans actually originated in 2001."[63]

The NAR's definition of "sensible lending standards" is driven by what serves its self-interest—more agent commissions—rather than the adverse impact on low- and moderate-income families and communities. If the FHA were to follow the NAR's advice and lower its FICO average but continue using its current risk layering, this would have disastrous

[60] Where one or more participating parties have a tendency to take risk because some other party is bearing the cost of that risk.
[61] See National Association of Home Builders, "Builder Confidence Continues to Gain Momentum in September," press release, September 18, 2012, www.nahb.org/news_details.aspx?sectionID=134&newsID=15515: "In particular, unnecessarily tight credit conditions are preventing many builders from putting crews back to work—which would create needed jobs—and discouraging consumers from pursuing a new-home purchase." And National Association of Realtors, "Home Sales and Job Creation Would Rise with Sensible Lending Standards," press release, September 17, 2012, www.realtor.org/news-releases/2012/09/home-sales-and-job-creation-would-rise-with-sensible-lending-standards.
[62] National Association of Realtors, "Home Sales and Job Creation."
[63] Ibid.

consequences for additional low- and moderate-income families that would now be receiving FHA-insured loans.

The NAR's push for looser underwriting is neither news nor a policy change. Near the height of the housing and mortgage bubble in 2006, then-NAR president Thomas Stevens was asked whether he was concerned about the group's survey finding that 43 percent of first-time home buyers put no money down. He answered that he wasn't, but would be "if the number was higher than that."[64]

There is no need to recount how disastrous this was for homeowners, particularly low- and moderate-income communities in the 2000s. But what does the NAR's perennial push for risk layering mean for FHA families living in low- and moderate-income communities today? The FHA insured an estimated 1.8 million home purchase loans during FY 2009 and 2010 that were in zip codes where the median family income was below the median for the metro area.[65]

- The estimated average sales price was $150,000.
- The average real estate commission in America is approximately 5.1 percent,[66] for total commissions of **$14 billion**.
- These FHA home buyers have accumulated estimated earned equity of 8.5 percent (4 percent down payment plus 4.5 percent from scheduled loan amortization over three years), resulting in total earned equity of **$23 billion**.
- These FHA home buyers have had an estimated 10.5 percent home price decline since June 2009 resulting in a negative equity total because of price decline: **$28 billion**.

The result is a current gross equity position of these FHA home buyers of **–$5 billion** and a current net equity position (net of 7 percent seller transaction costs) of **–$24 billion**.

The winners are real estate agents at **+$14 billion** and the losers are FHA home buyers in below-median-income zips at **–$5 billion (gross) and –$24 billion (net).**

The estimated FHA foreclosure rate for all home buyers in below-median-income zips is **10 percent.** For those home buyers in zips with highest foreclosure rates representing 50 percent of the loan volume in these below median income zips is **14 percent.**

Conclusions:

- Realtors' advantage in the housing market is not surprising given that real estate agents do not have 'skin-in-the-game' and the FHA entices higher-risk home buyers with its irresponsible lending practices.

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[64] Noelle Knox, "43% of First-Time Home Buyers Put No Money Down," *USA Today*, January 17, 2006, http://usatoday30.usatoday.com/money/perfi/housing/2006-01-17-real-estate-usat_x.htm .

[65] Purchase loans totaled 2.1 million. See US Department of Housing and Urban Development, *FHA Outlook*, FY 2010. This study indicates 85 percent of these would be in zips where the median family income was below the median for the area.

[66] "What Is an Average Real Estate Commission for This Area?" Zillow, July 18, 2009, www.zillow.com/advice-thread/What-is-an-average-real-estate-commission-for-this-area/257717/.

- Yet again, the NAR is more concerned about financial gains for its members than the harmful impact the underwriting changes that they espouse will have on low- and moderate-income families and communities.

The Consequences of the FHA's Excessive Leverage

The FHA's failure to apply risk-based pricing and underwriting standards guarantees failure for many low- and moderate-income families.[67] The FHA's experience demonstrates that insuring highly leveraged loans to lower-income borrowers with very low down payments and a 30-year loan term combined with impaired credit and high debt ratios results in excessive foreclosure and delinquency rates that are a disservice to these families and their communities.

Conclusions:

- It is time for the FHA to stop knowingly lending to people who cannot afford to repay their loans.
- It is time to return to what has worked in the past for FHA: insuring reduced-leverage loans for families who have impaired credit.

Reforming the FHA

Social policies that help low- and moderate-income families become homeowners have an important place, but they must balance the interest in low- and moderate-income lending against the risks to the borrowers and the interests of the taxpayers. In the past, "affordable housing" and similar policies have sought to produce certain outcomes—such as an increase in homeownership—which turned out to escalate the risks for both borrowers and taxpayers. The mortgages made in pursuance of social policies can be lower than prime quality—taxpayers may be willing to take risks to attain some social goods—but quality and budgetary limits must be placed on riskier lending to keep taxpayer losses within known and reasonable bounds.

Consistent with these policies, the FHA needs to return to its traditional mission of being a targeted provider of mortgage credit for low- and moderate-income Americans and first-time home buyers. The FHA performs a disservice to American families and communities by undertaking practices that result in a high proportion of families losing their homes.

Families looking for help from the FHA in buying a home want responsible lending solutions that do not finance failure and foster continued dependency. These include:

- A well-underwritten loan they can afford.
- Terms that will not expose them and their community to a high risk of default.
- The opportunity to build equity, provide security for their family, and have the down payment for their next home as their family grows.

[67] For purposes of this study, low and moderate income was defined at the zip code level. Within a metropolitan area: those zip codes with a median family income below the median family income for area. For non-metro areas: those zip codes below the statewide non-metro median family income.

- A financing path that does not force them into a cycle of delinquency, default, and foreclosure.

It is obvious that far too many families who took out FHA and other high-risk loans have seen their wealth destroyed, their credit severely damaged for many years into the future, and their neighborhoods sent into severe decline. This is particularly so for lower-income and minority families. As this study demonstrates, the FHA is now the prime mover in perpetuating such effects. Although one could focus on treating the symptoms (foreclosures, negative equity,[68] or insufficient income to support the mortgage payment), that will perpetuate the FHA's irresponsible lending practices. Focusing the FHA on responsible lending addresses the root causes: the FHA's ongoing underwriting practices that set borrowers up for failure and ensure continuing decline of neighborhoods while allowing the market and the judicial system to more rapidly correct existing problems in the housing market.

Four Principles for Responsible FHA Lending Reform

Principle 1: Step back from markets that can be served by the private sector. The FHA has significant advantages that allow it to offer much lower rates than the private sector. These include a free explicit federal guarantee and no need to earn a return on capital, pay taxes, or cover administrative costs. Unless these substantial advantages are narrowly targeted, they lead to unfair and dangerous competition with the prime and subprime private sector, political interference, and the muting of pricing signals. Over a period of three to five years, the FHA should return to a purchase market share of 10-15 percent rather than today's 30 percent.

Principle 2: Stop knowingly lending to people who cannot afford to repay their loans. Although the loans the FHA insured in 2009–11 are called its good books of business, its 2011 Actuarial Study projects that even under a rosy scenario, these guaranty books will experience an average cumulative foreclosure rate of 8.5 per 100 loans, or about 1 in 12 loans.[69] But averages can be deceiving. As this study has demonstrated, these foreclosures disproportionally impact low- and moderate-income families and communities. The FHA should target an average foreclosure rate of 5 percent, assuming no house price appreciation or depreciation, and limit the worst credit risk categories to a maximum claim rate of 10. It should also price for risk, since not doing so deprives the borrower of price information needed to understand the true risk. Until it does so, it should disclose to the borrower his or her expected claim rate, assuming no house price appreciation or depreciation.

Principle 3: Set loan terms that help homeowners establish meaningful equity in their homes with the goal of ending their dependence on FHA lending. FHA should balance the layering of risk factors such as high LTV ratio, low FICO score, 30-year loan term, and high

[68] Principal forgiveness would amount to resetting borrower equity from negative to zero or near zero. This equity reset (from a severe negative equity position to one that is merely bad) would be done mostly for a population of borrowers whose credit quality (FICO score) says the odds of failure are even greater now than when the loan was made. Thus, principal forgiveness perpetuates and extends the cycle of neighborhood decline. Also, any principal forgiveness program conditioned on delinquency will unquestionably lead to a skyrocketing delinquency rate as borrowers stand to improve their net worth by tens or hundreds of thousands of dollars if they stop making mortgage payments. The alternative is an unconditional principal forgiveness program that essentially reduces principal balances for all underwater FHA loans. The magnitude of negative equity in the FHA portfolio and the associated cost of forgiving principal are enormous.

[69] US Department of Housing and Urban Development, *2011 Actuarial Review*, Appendix G-7.

debt-to-income (DTI) ratio so as to allow borrowers to achieve meaningful equity and build wealth. It should limit its insurance to refinance loans where the lower rate is used enable a reduction in loan term so as to speed amortization and builds meaningful equity. FHA insurance should not be used to enable cash-out refinances, since those work against meaningful equity buildup and reduce the overall equity cushion vital to reducing price volatility in low- and moderate-income communities.

Principle 4: Concentrate on those home buyers who truly need help purchasing their first home. In FY 2011, 54 percent of FHA's dollar volume went to finance homes that were greater than 125 percent of an area's median house price, up from 22 percent in 2009. Given the FHA's mission is to help low- and moderate-income home buyers, the homes it finances should cost less than the median home price for an area. Additionally, first-time home buyers should be limited to an income of less than 100 percent of area median income and repeat home buyers to an income of less than 80 percent of area median income.

Adopting these four principles would return the FHA to its traditional mission of being a targeted provider of responsible mortgage credit to low- and moderate-income Americans and first-time home buyers.

Specific Reforms to Implement These Four Principles

The following sets forth a series of steps designed to implement the four principles. Implementing all of these steps will enable the FHA to return to its traditional mission of being a targeted provider of responsible mortgage credit to low- and moderate-income Americans and first-time home buyers.

Step 1: FHA will not knowingly insure a loan with a projected claim termination rate greater than 10 percent, assuming no house price appreciation or depreciation. This should be a central part of the FHA's definition of "qualified mortgage" and will demonstrate the FHA's "reasonable and good faith determination" that "the consumer has a reasonable ability to repay the loan."[70] To allow loans where the rate exceeds 10 percent would be a disservice to low- and moderate-income communities since these loans would be concentrated in working class neighborhoods.

Step 2: FHA will target an average 5 percent projected claim termination rate, assuming no house price appreciation or depreciation. This is well over five times the historic default level for prime loans and two times the historic default rate for 90 percent LTV ratio loans with private mortgage insurance. In addition to the underwriting changes noted in Step 5, the FHA should limit seller concessions to 3 percent of a home's value.

Step 3: Stop guaranteeing lower-risk loans and high-dollar-balance borrowers, as this allows for cross-subsidization of those loans with excessive risk. This will also let the FHA step back from markets that can be served by the private sector and allow it to concentrate on home buyers who truly need help. Start by limiting loans to 100 percent of county median house price. Additionally limit first-time home buyers to less than 100 percent of area median income and repeat buyers to less than 80 percent of area median income. Returning the FHA to its

[70] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, H.R. 4173, 111th Cong. (July 15, 2010), Section 1411.

mission as a targeted provider of mortgage credit for low- and moderate-income Americans and first-time home buyers has obvious benefits. It will return higher-income borrowers to the conventional lenders and private insurers market, resulting in a substantial reduction in foreclosure rate for higher income borrowers.

Step 4: Price for risk since not doing so deprives the borrower of the price information needed to understand the true risk of the loan. Until this is done, the FHA should disclose to the borrower his or her expected claim rate, assuming no house price appreciation or depreciation.

Step 5: Implement underwriting that results in the extension of responsible mortgage credit. Accomplish by balancing down payment, loan term, FICO score, and DTI ratio in a manner to achieve meaningful equity. Table 5 sets forth an approach for accomplishing this goal.

Table 5. Balance Down Payment, Loan Term, FICO, and Debt-to-Income Ratio to Achieve Meaningful Equity

FICO	Maximum LTV limit	Maximum loan term	Maximum total DTI	Equity after 4 years	MIP Upfront/annual
580+	97.25% (current)	30 years		8%	30 yr.: 1%/1.10-1.15% 15yr.: 1%/0.25-0.50%
660-675	95.5% (proposed)	30 years	<50%	10%	30 yr.: 1%/1.50%
620-659	95.5%/90% (proposed)	20/30 years	<50%/40%	16%/15%	21 yr.: 1%/1.50% 30 yr.: 1%/1.50%
580-621	92%/85% (proposed)	15/20 years	<45%/40%	26%/25%	15 yr.: 1%/1.50% 20 yr.: 1%/1.50%

Note: For ease of comparison, all examples are based on the purchase of a $100,000 home at the maximum LTV and term with a 30-year interest rate of 6 percent, a 20-year interest rate of 5.75 percent, and a 15-year interest rate of 5.5 percent. Maximum LTV with upfront mortgage insurance premium financed.
Source: Author.

The goal of the above underwriting policies is to reduce risk layering, particularly for borrowers with FICO scores below 660, by providing a trade-off between a lower down payment and a 30-year loan term. Home buyers would be offered one, not both. In each case, the earned equity from combination of down payment and scheduled loan amortization during the first four years is the same.

This approach places a greater reliance on reduced loan term than reduced debt ratio, since the reduced term has a greater positive impact. For the 620–659 FICO borrower, the additional payment (forced savings) on a 20-year term loan would account for about 6 percent of the debt ratio and would likely reduce the foreclosure rate by about 40 percent.[71] As a result earned

[71] This estimate is based on the FHA's actuarial estimates for the period 1997–2010. The FHA estimates its 15-year loan term claim termination rate is 29 percent of that for 30-year term loans (see various FHA Actuarial

equity from scheduled loan amortization doubles from from 8 percent (30-year term) to 16 percent (20-year term) over the first four years.

Contrast this with the same 620–659 FICO borrower where a 6 percent reduction in debt ratio would reduce the foreclosure rate by only about 10 percent and aarned equity from scheduled loan amortization would be unchanged at 8 percent (30-year term) over the first four years.

The Positive Policy Effects of More Responsible Underwriting

Responsible underwriting for the 580 to 675 FICO score band has many positive policy impacts.

It reinforces the FHA's traditional mission as a targeted provider of responsible mortgage credit for low- and moderate-income Americans and first-time home buyers. The 580–675 FICO score band contains about 23 percent of all individuals with a scoreable credit record, but as table 6 demonstrates, it is heavily weighted with low- and moderate-income Americans, minorities, and first-time home buyers. (These weights are underlined in table 6.)

Table 6. Responsible Underwriting Expands FHA's Targeted Mission, with Positive Policy Impacts

Category	% in 580-675 FICO*	Ratio to Non-Hispanic white
Non-Hispanic white	20.5%	1:1
Black	38%	1.9:1
Hispanic	30%	1.5:1
Low-income census tract (<50% of median)	33.5%	1.60:1
Moderate-income cen. tract (>49% & -<80% of median)	29.75%	1.45:1
Minority population >=80% for census tract	33.75%	1.65:1
Age: <30 years	31.1%	1.5:1
Age : 30-39 years	28%	1.35:1
Urban census tract	23%	1.1:1
Rural census tract	23.8%	1.16;1
All	23%	1.1:1

Source: Estimates based on Federal Reserve, *Report to the Congress*.

Because of lender FICO score overlays[72] and to bolster its deteriorating financial condition, the FHA reduced the percentage of its insured loans with a FICO score below 660. Increased loan limits and pricing advantages compared to a private mortgage insurance execution through the GSEs allowed the FHA to expand into the prime category (primarily in the FICO score band of 675–740). As a result, the FHA's average FICO score for FY 2012 (through August) was 695, up from 660 in 2007.

Studies). This rate conservatively estimated at 60 percent for a 20-year rate. This results in a 20-year loan having a 40 percent lower foreclosure rate than a 30-year loan.

[72] A lender FICO score overlay is when the originating lender has a higher minimum FICO score for borrowers than the FHA's minimum. This was largely a defensive measure to protect customers from extremely high expected foreclosure levels if they have low FICO scores and other risks, and to reduce the potential for indemnification requests.

Responsible underwriting policies designed around the 580–675 FICO score band would have positive policy effects:

- 23 percent of all individuals with a scoreable credit record are in this band.
- 38 percent of blacks have a FICO score in this band.[73]
- 30 percent of Hispanics have a FICO score in this band.[74]
- 32 percent of the residents of low- and moderate-income zips (less than 80 percent of median) have a FICO score in this band.
- 30 percent of those 39 years of age or younger have a FICO score in this band.

The FHA's minority purchase loan volume was 32 percent of the FHA's total purchase volume in FY 2012 (through August), the same as for FY 2011.

FHA's estimated FY 2012 purchase loan volume (based on FY 2011 results) is as follows:
- Black: 9.5 percent or 69,000 out of a total purchase loan volume of 727,000.
- Hispanic: 16.1 percent or 117,000 out of a total purchase loan volume of 727,000.

FY 2007 purchase loan volume:
- Black: 14.1 percent or 40,113 out of total purchase loan volume of 283,639.
- Hispanic: 12.7 percent or 36,089 out of total purchase loan volume of 283,634.

The FHA's home purchase loan market share has been 30–35 percent since 2009.[75] A 2011 white paper by the Treasury and HUD recommended:

> The FHA should return to its pre-crisis role as a targeted provider of mortgage credit access to low- and moderate-income Americans and first-time home buyers. (Today's FHA market share is nearly 30 percent, compared to its historic role of 10–15 percent.) As Fannie Mae and Freddie Mac's presence in the market shrinks, the Administration will coordinate program changes at FHA to insure the private market—not FHA—picks up that new market share.[76]

Assuming the FHA's purchase market loan share returned to, for example, 15 percent by 2015 and overall purchase loan volume was 25 percent higher than in 2012. The FHA's total purchase volume would be about 450,000 loans:
- Estimated purchase loan volume for blacks would be at least 14 percent (the percentage in FY 2007), or 63,000 loans.
- Estimated purchase loan volume for Hispanics would be at least 13 percent (the percentage in FY 2007), or 59,000 loans.

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[73] Another 33 percent have a FICO score below 580.
[74] Another 17 percent have a FICO score below 580.
[75] US Department of Housing and Urban Development, *Annual Report to Congress, Fiscal Year 2011 Financial Status, FHA Mutual Mortgage Insurance Fund*, November 15, 2011, http://portal.hud.gov/hudportal/documents/huddoc?id=fhammifannrptfy2011.pdf, figure 11.
[76] US Department of the Treasury and US Department of Housing and Urban Development, *Reforming America's Housing Finance Market*.

Additionally, as the FHA returns to its traditional focus, a more normal conventional market will develop, with expanded volume in the 675–720 FICO band.

Appendix A. Risk Factors

Risk factor: LTV	LTV Bucket	FICO Category	Debt Ratio	Sum (90+ Delq Count)	Sum (Loan Count)	Risk Bucket 90+ Rate	90+ Factor (risk bucket 90+ rate divided by total 90+ rate)	Times More Likely To Be 90+
	(95+]	580 - 599	(50,99]	412	1,705	24.2%	3.38	**1.62**
	(75,80]	580 - 599	(50,99]	24	161	14.9%	2.08	
	(95+]	620 - 659	(50,99]	5,046	37,260	13.5%	1.89	**1.42**
	(75,80]	620 - 659	(50,99]	152	1,591	9.6%	1.34	
	(95+]	720+	(50,99]	1,176	39,243	3.0%	0.42	**1.09**
	(75,80]	720+	(50,99]	26	949	2.7%	0.38	

Risk factor: Loan term	LTV Bucket	FICO Category	Debt Ratio	Loan Term	Sum (90+ Delq Count)	Sum (Loan Count)	Risk Bucket 90+ Rate	Times More Likely To Be 90+
	(95+]	580 - 599	(50,99]	>15	412	1,705	24.2%	**1.21**
	(95+]	580 - 599	(50,99]	<=15	5	25	20.0%	
	(95+]	620 - 659	(50,99]	>15	5,046	37,260	13.5%	**1.62**
	(95+]	620 - 659	(50,99]	<=15	16	191	8.4%	
	(95+]	720+	(50,99]	>15	1,176	39,243	3.0%	**2.04**
	(95+]	720+	(50,99]	<=15	5	341	1.5%	

Risk factor: Debt ratio	LTV Bucket	FICO Category	Debt Ratio	Sum (90+ Delq Count)	Sum (Loan Count)	Risk Bucket 90+ Rate	90+ Factor (risk bucket 90+ rate divided by total 90+ rate)	Times More Likely To Be 90+
	(95+]	580 - 599	(50,99]	412	1,705	24.2%	3.38	**1.66**
	(95+]	580 - 599	(0,25]	121	831	14.6%	2.04	
	(95+]	620 - 659	(50,99]	5,046	37,260	13.5%	1.89	**1.86**
	(95+]	620 - 659	(0,25]	837	11,515	7.3%	1.02	
	(95+]	720+	(50,99]	1,176	39,243	3.0%	0.42	**2.86**
	(95+]	720+	(0,25]	228	21,777	1.0%	0.15	

Risk factor: FICO category	LTV Bucket	FICO Category	Debt Ratio	Sum (90+ Delq Count)	Sum (Loan Count)	Risk Bucket 90+ Rate	90+ Factor (risk bucket 90+ rate divided by total 90+ rate)	Times More Likely To Be 90+
	(95+]	580 - 599	(50,99]	412	1,705	24.2%	3.38	**8.06**
	(95+]	720+	(50,99]	1,176	39,243	3.0%	0.42	
	(95+]	620 - 659	(50,99]	5,046	37,260	13.5%	1.89	**4.52**
	(95+]	720+	(50,99]	1,176	39,243	3.0%	0.42	

* About 49% of loans are missing total-debt-to-income data. The serious deliquency rate for these loans tend to sililer to loan categories with debt ratios greater than 45 percent.

Examining the Proper Role of the Federal Housing Administration in Our Mortgage Insurance Market

Edward J. Pinto

US House of Representatives

Financial Services Committee

February 6, 2013

Resident Fellow

American Enterprise Institute

The views expressed are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

FHA Poses a Triple Threat

- An extraordinary failure rate is a continuing threat to working-class families and communities
- Insolvency on an Regulatory Accounting Principle basis (so called economic value) and GAAP basis exposes taxpayers to bailout risk
- Unfair competition with private capital blocks Housing Finance Reform

This Is Not the First Time

"We have been fighting abuse, fraud, and neglect of the FHA program that has destroyed too many neighborhoods and too many families' dreams of homeownership for more than 25 years....The FHA program has a national default rate 3 to 4 times the conventional market, and in many urban neighborhoods it routinely exceeds 10 times. In addition, the FHA program is hemorrhaging money...."

Statement by the late-Gale Cincotta (founder of National Peoples Action) made before the Subcommittee on Housing and Community Opportunity of the House Financial Services Committee, April 1, 1998

Likewise, on October 8, 2009

- In testimony before the Subcommittee on Housing and Community Opportunity of the Financial Services Committee, I noted that the FHA had a $54 billion hole in its balance sheet, not the positive $2.7 billion as estimated by FHA's actuary:

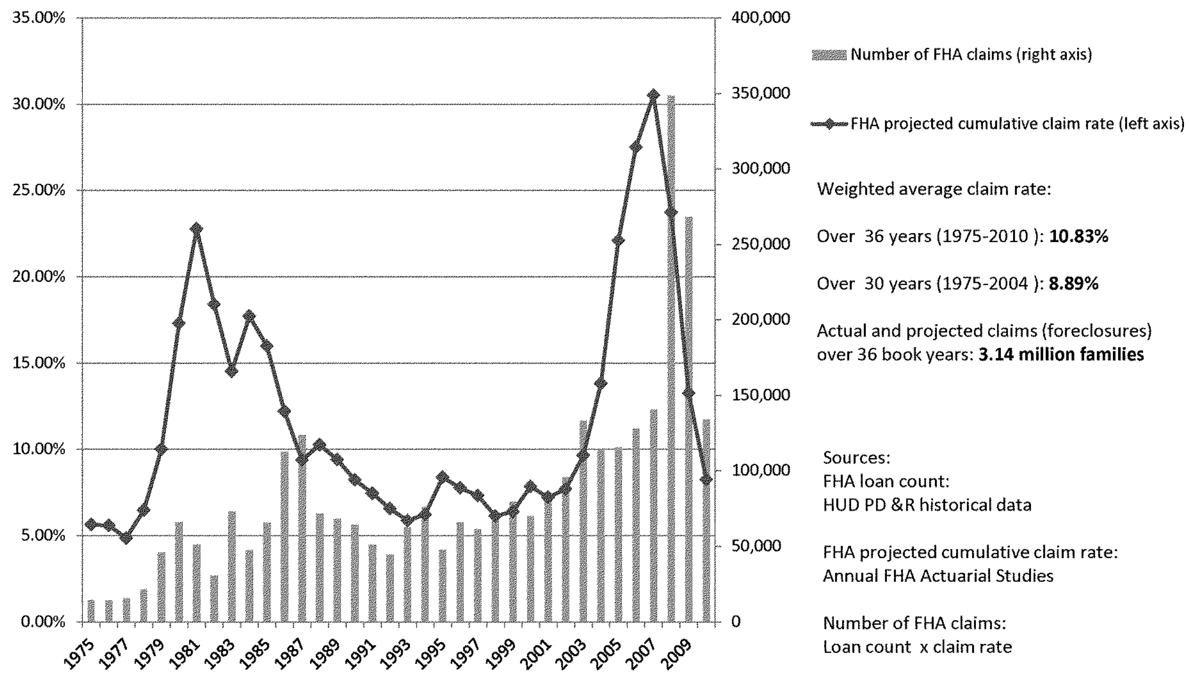
  " Based on my analysis FHA is short $40 billion in its Financing Account as of 9.30.09...[plus} an additional $14 billion [necessary to cover its 2% Capital Reserve Requirement]."

- As I will elaborate on momentarily, it has taken three years for the FHA to acknowledge it faces a massive capital shortfall on the order of $54 billion.

Continuing Threat to Posed by an Extraordinary Failure Rate

- Financing failure for working-class families and communities
  - 11%: weighted average claim (foreclosure) rate-1975-2011
  - Abusive lending practices has led to over 3 million failed American Dreams.
  - Foreclosure pain concentrated year after year on working class families and communities

FHA Claims and Claim Rate by Book Year



Weighted average claim rate:

Over 36 years (1975-2010): **10.83%**

Over 30 years (1975-2004): **8.89%**

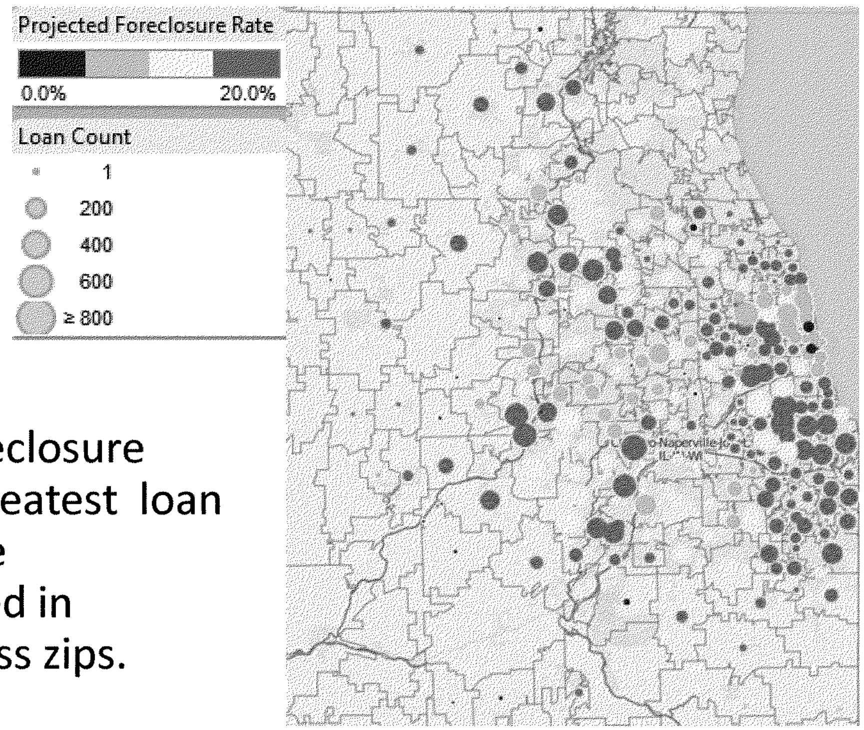
Actual and projected claims (foreclosures) over 36 book years: **3.14 million families**

Sources:
FHA loan count:
HUD PD &R historical data

FHA projected cumulative claim rate:
Annual FHA Actuarial Studies

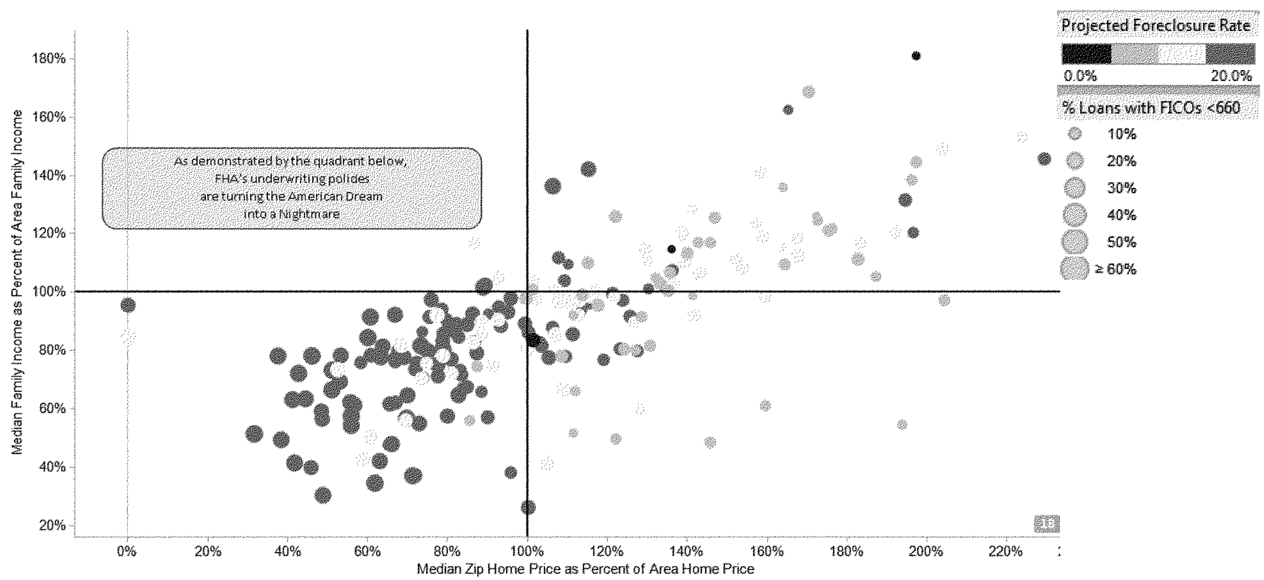
Number of FHA claims:
Loan count x claim rate

Chicago: Projected Foreclosure Rate



Highest foreclosure rates and greatest loan volumes are concentrated in working-class zips.

Chicago's Quadrant of Doom



Who Are the Enablers of Doom?

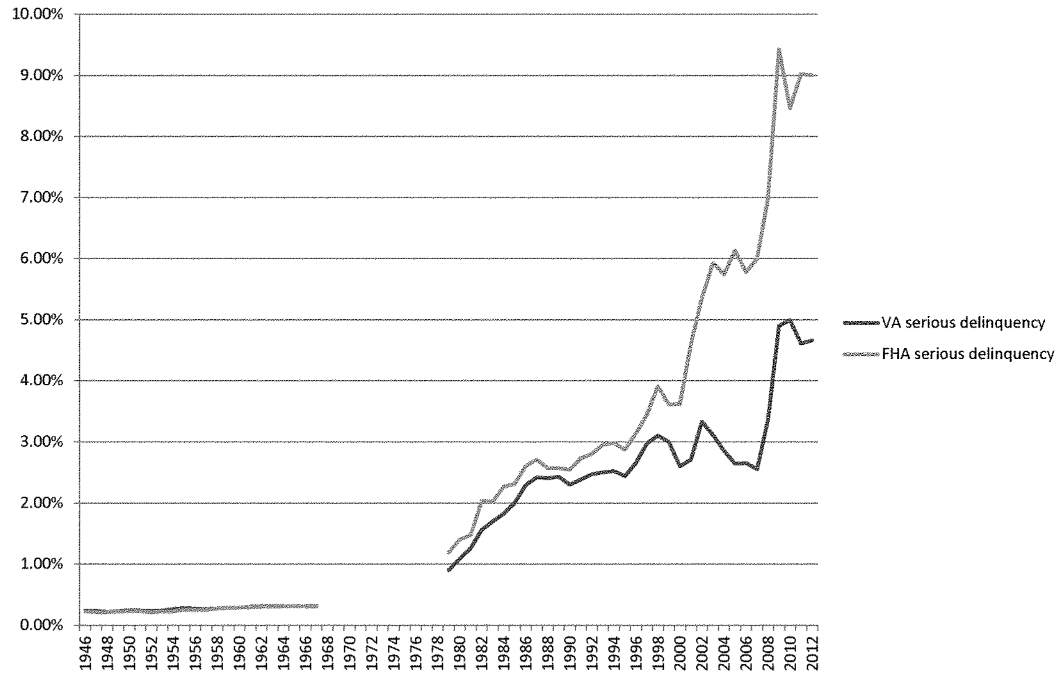
- **Investors** in Ginnie Mae MBS) are indifferent to loan quality since they are backed by the full faith and credit of the US Government.
- **Regulators** are indifferent since Ginnie MBS and FHA loans are backed by the full faith and credit of the US Government.
  - A "0" risk-based capital weighting (compared to a 20 percent for GSE MBS).
    - This encourages investment by domestic and foreign buyers. Foreign buyers hold an estimated 30 percent of outstanding Ginnie securities.
  - Ginnie MBS get a free pass under the QM provisions and are exempt by law from the risk retention provisions of the Dodd-Frank Act.
- **Ginnie Mae** is largely indifferent as it is insured against 100% of loss by the FHA (not the case with the VA).
  - **Ginnie Mae** provides a valuable subsidy to FHA that enables it to better compete for lower risk loans; loans that subsidize higher risk loans.
- **Real estate agents and home builders** (and the **NAR** and **NAHB** which represent them) are largely indifferent since they take their profits at loan closing.

Who Are the Enablers of Doom-cont'd?

- **Originators** make these risky loans because they are insured against loss by the FHA.
- **Borrowers** are indifferent since they are charged the same insurance premium regardless of whether it is a 30 year term loan with 96.5 percent LTV with a 580 FICO credit score and a 50 percent debt ratio or a 96.5 percent LTV with a 740 FICO credit score and a 50 percent debt ratio.
- By not pricing for risk, **FHA** (at the behest of **Congress**) keeps homebuyers in the dark with respect to loan risk.
  - A substantial percentage of **FHA** loans can be fairly characterized as abusive, even toxic loan products.
  - Normally risk based pricing would inform borrowers as to risk.
    - **FHA** does not disclose these extraordinarily high levels of risk to borrowers.
  - **FHA** is able to cover the outsized losses on these risky loans through the use of cross-subsidies funded by lower risk loans.
- **Congress**, the FHA's regulator, has been largely indifferent thanks to the convoluted "Federal Credit Reform Act."

FHA Lending Was Not Always This Risky

VA and FHA Serious Delinquency Rates



FHA’s Insolvency Puts Taxpayers at Risk (1)

- Even under generous accounting rules that no other financial entity gets to use, the FHA’s FY 2012 actuarial study reported that its main single-family insurance program has an economic value (EV) of *negative* $13.5 billion.
- However, on the date submitted to Congress, the base case was already obsolete, since it ignores the Fed’s September QE 3 announcement.
  - The projection of negative $13.5 billion was based on Moody’s July 2012 forecast projecting 10 Year Treasuries in CY Q1:13 to be about 3.25% and climbing to 4.59% by 2014. Under that same forecast, mortgage rates are projected to double to 6.58% by CY Q3:14.
  - Today the 10-year is at 2.02%.
  - If the study’s low interest rate scenario is substituted, FY 2012’s EV is a **negative $31 billion.** Add the $22 billion shortfall in required capital buffer and FHA is short over $50 billion. The SEC would be all over a public company that played by FHA’s rules.

FHA's Insolvency Puts Taxpayers at Risk (2)

- Each year you get the same report saying: don't worry, next year will be better.
  - Contrary to FHA's assertions, the FHA will be not be back to a near zero EV at the end of FY2013 or at anytime soon.
  - Of greater concern is that FHA is a recession away from catastrophic taxpayer losses.
- What do we know for sure about the FHA's fiscal condition?
  - Under Generally Accepted Accounting Principles (GAAP) FHA's net worth is estimated at *negative* $26 billion, with a total capital shortfall of $47 billion based on its 2% capital requirement.
  - Its cash is dwindling fast and may be exhausted within the next 12-18 months.
  - One in six FHA loans is delinquent 30-days or more and this rate has been growing.

By Unfairly Competing with Private Capital, Housing Finance Reform Is Blocked

- FHFA acting director Edward Demarco had this to say about the future of housing finance reform:

  > "One potential place to start is by clearly defining the role of the traditional government mortgage guarantee programs like the Federal Housing Administration (FHA)."

- As FHFA continues to implement Congress' appropriate mandate to align the GSEs' guarantee fees to appropriately reflect the risk of loss, as well the cost of capital allocated to similar assets held by other fully private regulated financial institutions, volume might instead shift to the Ginnie Mae agencies: FHA, VA, and USDA .

By Unfairly Competing with Private Capital, Housing Finance Reform Is Blocked

- Over the last five years, private mortgage insurers have added $11 billion in private capital.
  - Two new insurers have been capitalized:
    - Essent and National
- Redwood Trust has issued 11 private securitizations totaling $3.9bil and retained all risk bearing tranches.

Turning Hope Into Homes

- Step back from markets that can be served by the private sector; take steps to return to a traditional 10-15 percent home purchase market share.
- Stop knowingly lending to people who cannot afford to repay their loans.
- Help homeowners establish meaningful equity in their homes.
- Concentrate on homebuyers who truly need help purchasing their first home.

QM Continues the Same Policies that Led to the Financial Crisis

- Loans with 580 FICOs, 50% DTIs and 3% downpayments will be called **prime** loans instead of **subprime**
  - FHA insures loans like this today, and there is no reason that the GSEs will not in the future
- The 1.5% cap will restrain risky private lending but channel it through the GSEs and FHA

Step 1: Incorporate Provisions from House-passed FHA Bill

- Sec. 2: Establish minimum upfront and annual premiums
- Sec. 3: Indemnification by FHA mortgagees
- Sec. 4 Early period delinquencies—amend to automatic buy-back for defaults within 6-months
- Section 5: Semiannual actuarial studies—amend to quarterly updates as part of existing quarterly report to Congress.
- Section 7: Authority to terminate FHA Mortgagees
- Section 15: Require an independent safety and soundness review under GAAP and statutory regulatory accounting applicable to the private sector.
- Section 16: Apply an SEC-style disclosure standard to FHA

Step 2: Apply proven VA best practices to FHA

- Reduce maximum claim coverage to 80 percent from the current 100 percent, with an ultimate goal of 25 percent.
- Reinstate the use of an appraisal board.
  - This would replace the current system where the lender chooses the appraiser.
  - This would help assure the quality of homes bought by working class families.
- Require the use of residual income.
  - This is consistent with CFPB advice on higher debt-to-income loans

Step 3: Needy Families Need FHA's Full Attention (1)

- Focus on working class families & neighborhoods by replacing a mortgage limit with an income test
- Set maximum FICO score at 675 (580-675 range =25% of all households and 40% of Blacks, >675 = 64% of all households and 28% of Blacks).
- Eliminate specific risks that are difficult to offset with lower-risk features:
  - FICO scores below 580 (11% of all households, 33% of Black).
  - Adjustable rate mortgages.
  - Seller concessions greater than 3 percent.

Step 3: Needy Families Need FHA's Full Attention (2)

Credit Score Distribution by Demographic Groups

	Fed study interest rate	Fed study credit score distribution	Fed study default rate	FHA serious delinquency rate	Non-Hispanic white	Black	Hispanic
Credit score band							
<580	9.56%	11%	30%	30%	8%	33%	17%
580-619	8.94%	8.50%	18%	20%	7%	20%	13%
620-659	7.30%	10.50%	14%	11%	9%	15%	16%
660-719	6.40%	19%	5%	2%	20%	17%	24%
>719	6.10%	51%	1%		55%	16%	30%
Some results interpolated to standardize across credit score bands							

Source: Federal Reserve, *Report to the Congress on Credit Scoring and Its Effects on the Availability and Affordability of Credit*, May 2007, www.federalreserve.gov/boarddocs/rptcongress/creditscore/creditscore.pdf.

Step 3: Needy Families Need FHA's Full Attention (3)

Responsible Underwriting Expands FHA's Targeted Mission, with Positive Policy Impacts

Category	% in 580-675 FICO*	Ratio to Non-Hispanic white
Non-Hispanic white	20.5%	1:1
Black	38%	1.9:1
Hispanic	30%	1.5:1
Low-income census tract (<50% of median)	33.5%	1.60:1
Moderate-income cen. tract (>49% & -<80% of median)	29.75%	1.45:1
Minority population >=80% for census tract	33.75%	1.65:1
Age: <30 years	31.1%	1.5:1
Age : 30-39 years	28%	1.35:1
Urban census tract	23%	1.1:1
Rural census tract	23.8%	1.16;1
All	23%	1.1:1

Source: Estimates based on Federal Reserve, *Report to the Congress.*

Step 4: Establish a Tolerance for Failure (1)

- Key policy question: what is the tolerance for financing failure?
  - What is the tolerance given the concentration of failure that occurs with respect to working class families and neighborhoods?
  - Limit/adjust risk layering to meet target projected average claim rates of 5-6 per 100 insured loans under normal circumstances and 10 per 100 insured loans under stress circumstances.
  - Risk balance down payment, loan term, and debt-to-income when FICO <660.

Step 4: Establish a Tolerance for Failure (1)

Balance Down Payment, Loan Term, FICO, and Debt-to-Income Ratio to Achieve Meaningful Equity

FICO	Maximum LTV limit	Maximum loan term	Maximum total DTI	Equity after 4 years	MIP Upfront/annual
580+	97.25% (current)	30 years		8%	30 yr.: 1%/1.10-1.15% 15yr.: 1%/0.25-0.50%
660-675	95.5% (proposed)	30 years	<50%	10%	30 yr.: 1%/1.50%
620-659	95.5%/90% (proposed)	20/30 years	<50%/40%	16%/15%	21 yr.: 1%/1.50% 30 yr.: 1%/1.50%
580-621	92%/85% (proposed)	15/20 years	<45%/40%	26%/25%	15 yr.: 1%/1.50% 20 yr.: 1%/1.50%

Note: For ease of comparison, all examples are based on the purchase of a $100,000 home at the maximum LTV and term with a 30-year interest rate of 6 percent, a 20-year interest rate of 5.75 percent, and a 15-year interest rate of 5.5 percent. Maximum LTV with upfront mortgage insurance premium financed.
Source: Author.

Step 4: Establish a Tolerance for Failure (2)

- A 5-6% FHA claim rate is both desirable and feasible
  - It is not true that only lending to high-risk borrowers (low-income and first-time borrowers with less than 680 FICO scores) would inevitably force up FHA claim rates and make FHA even more insolvent.
  - About 24% of all households (not homeowners) have a FICO of 580-675. This market segment provides plenty of potential borrowers for FHA to responsibly insure.
- Implementing the risk mitigation steps outlined on the previous slide, along with sensible process reforms such as a return to appraisal panels, the use of residual income, and a limit seller concessions to 3%, would result in:
  - An average FIC0 of about 640 (FHA is at 700 today), which would not compete with the private sector.
  - Loans with a weighted average claim rate of 5-6%.

Step 5: Fiscal Reform

- Use of generally accepted accounting principles (GAAP) applicable for private mortgage insurers with respect to quarterly examinations of the FHA's financial condition.
- Require the maintenance of a minimum capital level of 4% calculated in accordance with GAAP as applied to private mortgage insurers.
- Set FHA's premium structure where 50 percent of the premium is sufficient to meet normal claim expectations on insured loans.
  - Unused portions would accumulate in the capital reserve account.
  - The remaining 50 percent would accumulate in a separate countercyclical catastrophic premium reserve for a 15-year period and would be available to pay catastrophic losses from periodic but unpredictable general economic risks.

Reform Merits Bi-partisan Support

- Positive impact of FHA providing responsible lending to borrowers with 580-675 FICO scores:
  - Refocuses FHA to its core mission of responsibly serving working class families and communities.
  - 580-675 FICO score band has 24 percent of individuals with a scoreable credit record, but contains:
    - 34 percent of low- and moderate-income Americans,
    - 38 and 30 percent of Blacks and Hispanics, and
    - 31 percent of under age 30 individuals.
  - Responsible reforms can serve this group, cut FHA's historic failure rate in half, and not increase FHA's fiscal challenges.
- These steps will go a long way in eliminating the Quadrants of Doom.
- FHA's primary mission must be to serve working class families and communities, not the interests of the NAR and other lobby groups.
- I pledge to work with any member to make this a reality.

"FHA: The Need to Scale Back Their Market Share"

Prepared for

HEARING ON FEBRUARY 6, 2013
BEFORE
THE COMMITTEE FINANCIAL SERVICES,
U.S. HOUSE OF REPRESENTATIVES

WRITTEN TESTIMONY OF ANTHONY B. SANDERS
Senior Scholar, The Mercatus Center
Professor of Real Estate and Finance, School of Management
George Mason University, Fairfax, Virginia

I. Introduction

Chairman Hensarling and distinguished members of the committee, thank you for the invitation to testify at today's hearing on "Examining the Proper Role of the Federal Housing Administration in our Mortgage Insurance Market" and to provide my perspective on the ongoing mortgage debacle, the resulting decline in the private mortgage insurance market and the need to return the FHA's share of the insurance market back to pre-bubble levels. I am Anthony B. Sanders, Senior Scholar at George Mason University.

The Federal Housing Administration (FHA) has seen its conforming loan limit surge to $729,750 (1 unit) for high balance loans while mortgage giants Fannie Mae and Freddie Mac have seen their conforming loan limits for high balance loans fall to $625,500 (1 unit). When this artificially high conforming loan limit is combined with the FHA's high loan-to-value (LTV) and low credit score polices, we have a recipe for inordinate harm to fragile households.

II. FHA's Market Share and Risky-lending Profile

The FHA's market share surged from below 5% during the housing bubble to over 30% in 2008 (see Figure 1). To be sure, the decline in FHA share during the housing bubble was in part due to the rise of private-label securitizations (see Figure 2). As the FHA's share of mortgage originations (insured) is at over 25%, it is time for the footprint of the FHA to shrink back to previous market shares such as in 2003 when it was around 10%.

In terms of loan-to-value ratio, the FHA insures a large percentage of low down payment, high LTV loans (see Figure 3). The percentage of FHA's book that was high LTV (>= 5% down payment) was around 33% in 1990. That percentage almost double by 1995 to 62.36% as the Clinton Administration adopted "The National Homeownership Strategy: Partners in the American Dream" calling for lower down payments and streamlined financing.[1] The share of high LTV loans has risen to 71.52% in 2012 (although it peaked in 2000 at 84.61%.

In terms of credit (or FICO) scores, the FHA's data is very spotty prior to 2005. But from 2005 to 2012, the percentage of borrowers with low FICO scores (defined as 680 or below) peaked in 2007 at 80.58% (see Figure 4). The percentage of low FICO borrowers has declined to 42.54% in 2012, a noticeable improvement.

What is the result of the FHA's low down payment and low FICO policies? The FHA's book of loans in 2008 has been nothing short of disastrous (see Figure 5). To be sure, unemployment rose dramatically in 2008 as house prices declined rapidly (see Figure 6) which contributed to poor loan performance on most mortgages, particularly low FICO and low down payment loans.

To observe the dangers to households (and taxpayers) of low down payment loan coupled with low FICO scores, see the loan performance of Enterprise (e.g., Fannie Mae and Freddie Mac) purchased fixed-rate mortgages. The low risk loans are defined in each year as FICO score >= 660 and LTV <= 80% and are in the upper right hand corner. The high risk loans are defined as FICO score < 660 and LTV > 80%. These high risk loans are found in the lower left had corner. The coloring of yellow and orange signify excessively high 90% delinquency rates.

For example, for the 2007 vintage of Enterprise-purchase mortgages, the serious delinquency rate for FICO scores < 620 and LTVs >= 97.5 and <= 104.9 was 51.6%.

The typical domain of the FHA is the lower left hand corner: the high risk loans.

III. Does FHA Help or Harm American Households?

In President Thomas Jefferson's inaugural address of 1801, he stated:

"Still one thing more, fellow citizens, a wise and frugal government, which shall restrain men from injuring one another, shall leave them otherwise free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned. This is the sum of good government; and this is necessary to close the circle of our felicities."

Jefferson's statement applies to the FHA which has harmed American households through insuring risky (low FICO) loans with minimal down payments. This is very poor public policy.

An example of harming American households can be seen in Figure 7 (courtesy of Ed Pinto at the American Enterprise Institute). [2] Expected foreclosure rates in the Greater Washington DC are clustered

[1] http://confoundedinterest.files.wordpress.com/2013/01/nhsdream2.pdf

[2] http://www.aei.org/files/2013/01/07/-how-the-fha-hurts-workingclass-families-and-communities_133838366627.pdf

almost exclusively in working class neighborhoods in Maryland. While homeownership may be the American dream, insuring high risk borrowers increases the likelihood of a disaster.

III. Reducing Loan Limits

The FHA's loan limit is now higher than the conforming loan limits for Fannie Mae and Freddie Mac. But both the conforming loan limits and the FHA's loan limit rose dramatically in 2008 as house prices collapsed. The first step towards shrinking the FHA's footprint is to reduce the loan limit to $625,000 and by another $100,000 per year.

According to a study by Robert Van Order and Anthony Yezer of George Washington University[3] they find that current FHA policies are unlikely to assist the FHA in reaching its historical constituencies – first-time, minority and low-income homebuyers.

"We find that FHA's current market share exceeds what is needed to serve these markets," Van Order continued. "In the wake of significant declines in home prices, we believe FHA could reduce its loan limits by approximately 50 percent and still almost entirely satisfy its target market. That would reduce its currently large market share, which is difficult for FHA to manage."

IV. Installing a Credit Score Floor and DTI and LTV Ceilings

In order to protect households (and taxpayers), a floor should be installed for FHA insured loans at 660. As you can see in Table 1, loan performance deteriorates rapidly with FICO scores below 660.

In addition, a maximum LTV of 95% should be applied. And if the FICO score if below 680, a 10% minimum down payment should be required.

A maximum mortgage debt to income of 31 percent should be established as well.

V. FHA 30 Year Spread

The FHA has the highest spread of FHA 30 mortgage rates to GNMA 30 year current coupon rate (the rate paid to GNMA investors) of any of the government finance entities, including Fannie Mae and Freddie Mac. (see Figure 9). The spread is considerably above levels prior to 2008. In other words, the Federal Reserve's manic pushing of interest rates and mortgage rates downwards is NOT getting passed through to borrowers as had been hoped.

VI. Summary

The FHA's low down payment, low FICO score policies with a 100% guarantee encourages risk taking by working class households when there is a viable alternative: renting. But simple adjustments to FHA's policies of 1) FICO score floor of 660, 2) minimum down payment of 5%, 3) lower loan limit to $625,000

[3] http://business.gwu.edu/creua/research-papers/files/FHA2011Q2.pdf

and eventually to \$350,000 (or less), and 4) lower the insurance coverage to 80%. All these measures can serve to reduce the FHA's substantial, high-risk footprint in the mortgage market.

Thank you for the opportunity to testify.

Figure 1. FHA as a Percentage of Mortgage Originations By Type

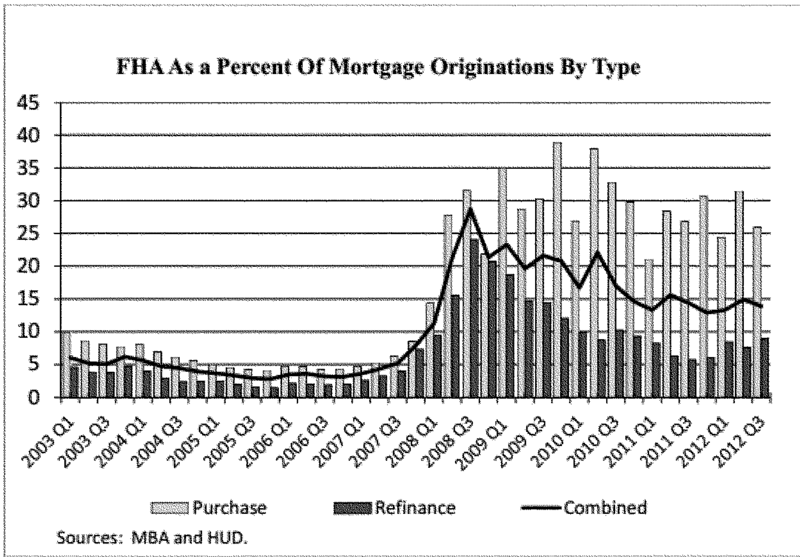


Figure 2. Market Shares of GSE, FHA and Private Label Securitizations

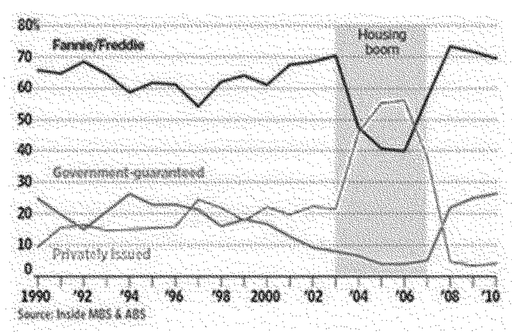
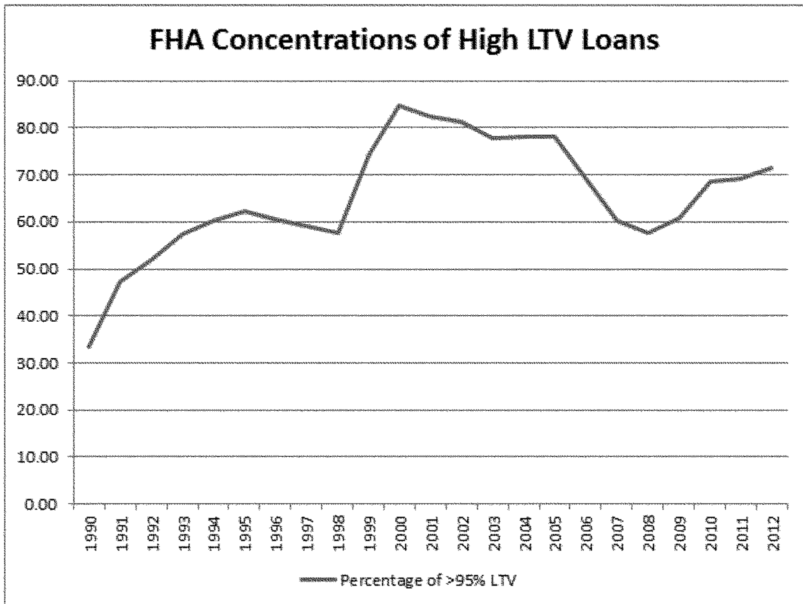
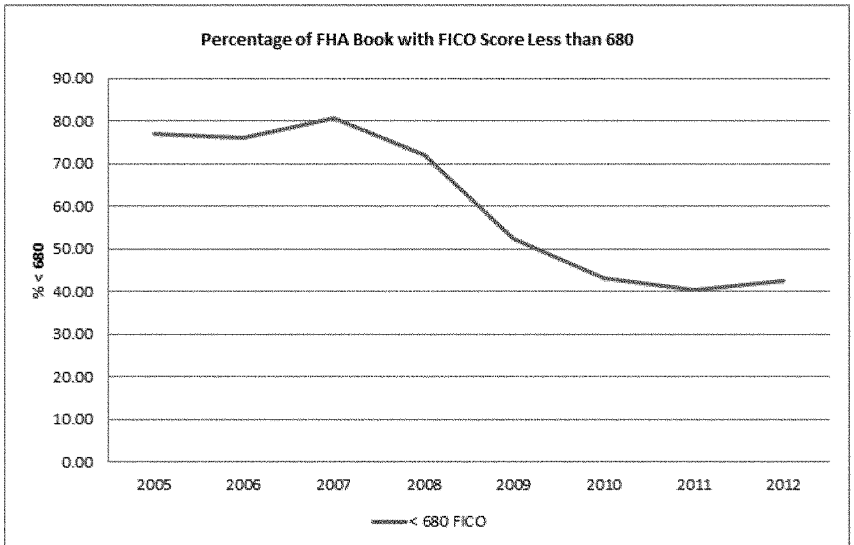


Figure 3. FHA Concentration of High Loan-to-Value Loans



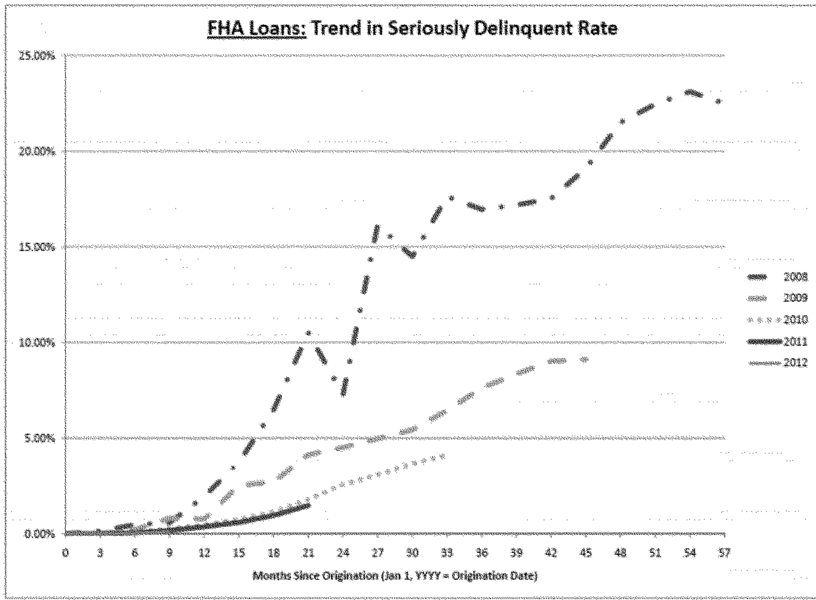
Source: Mortgage Bankers Association

Figure 4. Percentage of FHA Book with Credit Scores Less Than 680



Source: Mortgage Bankers Association

Figure 5. Trend in Serious Delinquency Rate for FHA Loans



Source: Mortgage Bankers Association

Figure 6. Case-Shiller 10 HPI and U6 Unemployment

Table 1. Enterprise-acquired Fixed-rate Mortgages, 90+ Day Delinquent, 2001-2004.

Enterprise-Acquired FRMs, 2001

LTV Bucket (%)	FICO Bucket: Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
Missing	0.0%	100.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	4.3%
0 - 59.9	1.0%	6.3%	3.1%	2.1%	1.4%	0.9%	0.6%	0.4%	0.2%	0.7%
60 - 69.9	1.3%	8.0%	4.2%	2.9%	1.9%	1.1%	0.7%	0.5%	0.3%	1.2%
70 - 74.9	1.9%	9.8%	5.5%	3.8%	2.5%	1.6%	1.1%	0.7%	0.3%	1.8%
75 - 79.9	1.8%	9.7%	5.7%	4.3%	2.9%	1.9%	1.3%	0.8%	0.4%	2.0%
80.0	1.8%	10.6%	6.8%	4.9%	3.5%	2.3%	1.5%	1.0%	0.5%	2.3%
80.1 - 84.9	3.0%	14.1%	8.9%	7.0%	4.8%	3.4%	2.2%	1.5%	0.8%	4.2%
85 - 89.9	3.2%	15.1%	9.5%	7.4%	5.2%	3.7%	2.6%	1.7%	1.0%	4.6%
90.0	3.9%	16.6%	11.4%	8.4%	6.4%	4.7%	3.5%	2.3%	1.4%	5.4%
90.1 - 94.9	4.1%	16.4%	10.8%	8.1%	5.9%	3.7%	2.7%	1.8%	0.9%	4.9%
95 - 97.4	10.3%	18.0%	12.4%	9.1%	6.3%	4.7%	3.2%	2.3%	1.4%	6.3%
97.5 - 104.9	14.5%	22.7%	14.1%	9.8%	6.9%	5.4%	3.8%	3.0%	1.8%	6.5%
105 +	9.7%	30.3%	18.2%	10.1%	8.5%	12.6%	13.8%	6.6%	3.4%	10.3%
Total	3.0%	11.9%	7.5%	5.4%	3.6%	2.4%	1.6%	1.0%	0.5%	2.5%

Enterprise-Acquired FRMs, 2002

LTV Bucket (%)	FICO Bucket: Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
Missing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
0 - 59.9	0.5%	5.7%	2.8%	1.9%	1.3%	0.8%	0.6%	0.4%	0.2%	0.6%
60 - 69.9	0.7%	7.6%	4.3%	3.0%	2.1%	1.3%	0.9%	0.6%	0.3%	1.2%
70 - 74.9	1.4%	9.6%	5.1%	3.7%	2.6%	1.8%	1.2%	0.8%	0.4%	1.8%
75 - 79.9	1.4%	9.2%	5.9%	4.2%	3.1%	2.1%	1.5%	1.0%	0.5%	2.0%
80.0	1.9%	10.3%	6.6%	4.9%	3.6%	2.5%	1.9%	1.3%	0.6%	2.4%
80.1 - 84.9	3.8%	13.6%	8.3%	6.6%	4.2%	3.4%	2.6%	1.9%	1.0%	4.2%
85 - 89.9	3.4%	14.9%	9.8%	7.2%	5.5%	4.1%	3.0%	2.2%	1.2%	4.9%
90.0	4.5%	15.3%	10.4%	8.5%	7.1%	5.3%	4.0%	2.9%	1.8%	5.6%
90.1 - 94.9	5.6%	16.2%	10.9%	8.0%	6.0%	4.4%	3.3%	2.3%	1.2%	5.4%
95 - 97.4	12.5%	17.4%	11.6%	8.8%	6.5%	5.1%	3.9%	2.9%	1.7%	6.5%
97.5 - 104.9	19.4%	25.3%	15.4%	11.5%	8.9%	6.7%	5.3%	3.6%	2.5%	9.1%
105 +	9.3%	19.5%	13.0%	10.8%	9.3%	9.0%	5.2%	3.7%	1.8%	7.0%
Total	2.9%	11.4%	7.0%	5.1%	3.6%	2.4%	1.7%	1.1%	0.5%	2.3%

Enterprise-Acquired FRMs, 2003

LTV Bucket (%)	FICO Bucket: Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
Missing	0.0%	2.6%	0.0%	10.7%	0.0%	0.0%	0.0%	0.0%	1.4%	1.4%
0 - 59.9	0.3%	6.5%	3.8%	2.9%	2.0%	1.3%	0.9%	0.6%	0.2%	0.8%
60 - 69.9	0.5%	8.5%	5.5%	4.1%	2.9%	2.1%	1.5%	1.1%	0.4%	1.6%
70 - 74.9	0.7%	10.3%	7.0%	5.1%	3.7%	2.7%	2.0%	1.4%	0.6%	2.3%
75 - 79.9	0.8%	10.5%	7.0%	5.7%	4.2%	3.2%	2.3%	1.6%	0.8%	2.6%
80.0	1.0%	11.8%	8.0%	6.3%	5.0%	3.7%	2.8%	2.0%	1.0%	3.0%
80.1 - 84.9	1.8%	13.4%	9.4%	7.8%	5.7%	4.2%	3.2%	2.2%	1.2%	4.4%
85 - 89.9	2.0%	14.3%	10.2%	8.2%	6.5%	4.9%	3.7%	2.8%	1.5%	4.9%
90.0	3.0%	15.7%	11.6%	9.1%	8.3%	6.2%	5.1%	3.8%	2.4%	6.1%
90.1 - 94.9	3.5%	16.9%	12.4%	9.5%	7.3%	5.1%	3.9%	2.8%	1.5%	5.7%
95 - 97.4	9.5%	18.0%	13.3%	10.3%	8.3%	6.6%	4.9%	3.9%	2.4%	7.2%
97.5 - 104.9	28.2%	30.8%	19.6%	15.0%	10.6%	8.7%	6.5%	5.2%	3.2%	12.5%
105 +	5.9%	21.3%	11.4%	11.8%	9.8%	7.0%	5.0%	3.7%	1.2%	6.4%
Total	1.8%	12.3%	8.1%	6.1%	4.5%	3.2%	2.3%	1.6%	0.6%	2.5%

Enterprise-Acquired FRMs, 2004

LTV Bucket (%)	FICO Bucket: Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
Missing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
0 - 59.9	0.6%	8.9%	5.6%	3.9%	2.7%	2.1%	1.5%	1.0%	0.4%	1.4%
60 - 69.9	0.8%	12.0%	7.8%	6.3%	4.5%	3.4%	2.5%	1.8%	0.8%	2.9%
70 - 74.9	1.4%	14.0%	9.3%	7.4%	5.9%	4.4%	3.2%	2.3%	1.1%	4.0%
75 - 79.9	0.9%	13.6%	10.3%	7.9%	6.4%	4.8%	3.8%	2.6%	1.3%	4.2%
80.0	1.0%	14.3%	10.3%	8.4%	6.4%	5.2%	3.9%	2.9%	1.4%	4.0%
80.1 - 84.9	2.3%	16.8%	11.9%	9.5%	8.1%	6.5%	4.7%	3.5%	1.7%	6.5%
85 - 89.9	1.8%	17.7%	12.7%	10.8%	8.4%	6.5%	6.3%	4.0%	2.2%	7.0%
90.0	3.1%	18.5%	14.1%	12.1%	9.6%	8.1%	6.5%	5.1%	3.4%	7.9%
90.1 - 94.9	4.2%	20.8%	14.8%	11.7%	8.5%	6.6%	4.7%	3.4%	2.2%	7.5%
95 - 97.4	7.2%	20.8%	15.3%	12.5%	10.3%	8.3%	6.5%	5.2%	3.4%	9.1%
97.5 - 104.9	25.6%	31.8%	22.0%	17.4%	13.3%	11.1%	8.7%	6.9%	4.3%	14.8%
105 +	9.2%	26.9%	18.4%	14.4%	11.2%	9.6%	5.3%	4.7%	2.5%	10.2%

Table 1a. Enterprise-acquired Fixed-rate Mortgages, 90+ Day Delinquent, 2005-2008.

Enterprise-Acquired FRMs, 2005											
		FICO Bucket									
		Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
LTV Bucket (%)	Missing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	0 - 59.9	2.1%	12.4%	8.4%	6.5%	4.9%	3.3%	2.3%	1.8%	0.6%	2.3%
	60 - 69.9	6.0%	17.7%	13.3%	11.0%	8.7%	6.8%	5.0%	4.1%	1.7%	5.4%
	70 - 74.9	6.4%	20.5%	16.2%	13.5%	11.0%	8.6%	6.8%	5.1%	2.3%	7.2%
	75 - 79.9	4.5%	18.8%	16.2%	13.6%	11.4%	9.3%	7.0%	5.7%	2.6%	7.3%
	80.0	5.3%	19.6%	16.4%	14.3%	11.6%	9.5%	7.8%	6.1%	3.0%	7.1%
	80.1 - 84.9	12.4%	21.2%	18.0%	15.0%	11.1%	10.0%	7.4%	5.9%	3.3%	9.5%
	85 - 89.9	7.6%	21.8%	18.8%	16.0%	13.2%	10.5%	9.1%	7.4%	3.7%	10.4%
	90.0	7.4%	23.1%	19.5%	17.5%	15.4%	13.3%	12.4%	9.8%	6.1%	12.1%
	90.1 - 94.9	12.2%	23.4%	18.2%	15.7%	12.0%	10.2%	8.2%	6.0%	3.4%	10.0%
	95 - 97.4	13.5%	25.9%	21.0%	18.4%	15.2%	13.0%	11.4%	9.1%	5.6%	12.8%
	97.5 - 104.9	35.2%	38.1%	29.4%	23.8%	18.9%	16.3%	12.8%	9.7%	6.0%	19.3%
	105 +	10.8%	33.1%	13.4%	9.4%	9.9%	6.5%	4.1%	7.8%	1.9%	10.1%
Total		13.4%	20.5%	16.7%	13.9%	11.0%	8.7%	6.8%	5.2%	2.2%	6.9%

Enterprise-Acquired FRMs, 2006											
		FICO Bucket									
		Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
LTV Bucket (%)	Missing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	0 - 59.9	2.6%	15.5%	11.3%	8.7%	6.4%	4.8%	3.4%	2.7%	0.9%	3.4%
	60 - 69.9	4.4%	23.7%	18.9%	15.9%	13.1%	10.4%	8.6%	6.6%	2.7%	8.3%
	70 - 74.9	7.6%	27.8%	22.7%	20.6%	16.8%	14.3%	11.5%	9.4%	4.4%	11.7%
	75 - 79.9	8.7%	25.2%	23.1%	20.9%	17.9%	15.5%	12.7%	10.0%	4.9%	11.8%
	80.0	6.6%	25.9%	24.2%	21.3%	19.3%	16.6%	14.0%	10.9%	5.3%	11.8%
	80.1 - 84.9	10.4%	27.1%	22.5%	20.3%	16.9%	16.1%	11.8%	10.3%	5.7%	14.1%
	85 - 89.9	11.0%	28.1%	24.4%	21.9%	19.4%	16.8%	14.1%	11.4%	6.2%	15.3%
	90.0	8.1%	30.2%	26.0%	23.1%	21.9%	19.7%	16.2%	14.4%	9.1%	17.0%
	90.1 - 94.9	6.0%	28.3%	25.5%	20.1%	15.9%	13.8%	12.1%	9.3%	5.8%	13.8%
	95 - 97.4	11.6%	33.3%	27.5%	23.2%	19.3%	18.8%	16.4%	13.2%	8.6%	17.3%
	97.5 - 104.9	49.7%	47.8%	36.0%	29.6%	25.0%	20.2%	16.1%	12.6%	7.8%	25.8%
	105 +	0.0%	29.9%	18.3%	11.2%	19.9%	18.1%	9.8%	5.8%	7.6%	15.7%
Total		21.9%	28.5%	23.8%	20.2%	17.1%	14.4%	11.6%	9.1%	4.1%	11.1%

Enterprise-Acquired FRMs, 2007											
		FICO Bucket									
		Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
LTV Bucket (%)	Missing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	0 - 59.9	2.6%	18.3%	11.7%	9.1%	6.4%	4.9%	3.6%	2.5%	0.8%	3.4%
	60 - 69.9	6.9%	27.8%	18.8%	16.2%	13.5%	11.3%	8.8%	6.9%	2.6%	8.4%
	70 - 74.9	9.4%	33.2%	23.7%	20.3%	17.3%	15.4%	12.4%	9.5%	4.2%	12.1%
	75 - 79.9	7.0%	29.8%	24.6%	20.7%	18.3%	16.2%	13.6%	10.9%	5.1%	12.2%
	80.0	6.4%	29.8%	25.0%	21.3%	18.9%	16.7%	14.2%	10.7%	4.8%	11.6%
	80.1 - 84.9	3.8%	31.7%	25.4%	23.0%	20.6%	19.8%	17.8%	13.5%	7.5%	17.4%
	85 - 89.9	5.6%	35.1%	30.5%	26.2%	22.7%	22.1%	18.7%	15.2%	8.4%	19.6%
	90.0	8.8%	36.5%	31.4%	27.5%	25.6%	24.0%	20.6%	17.1%	9.8%	20.4%
	90.1 - 94.9	4.8%	34.1%	28.3%	26.4%	20.5%	21.6%	18.5%	14.2%	7.6%	18.1%
	95 - 97.4	12.6%	41.8%	31.2%	28.1%	24.8%	27.0%	23.4%	19.0%	10.6%	22.2%
	97.5 - 104.9	43.2%	51.6%	42.0%	35.5%	29.8%	24.7%	21.0%	16.0%	10.5%	29.5%
	105 +	11.0%	32.0%	20.4%	27.6%	20.6%	23.7%	19.9%	12.9%	10.7%	17.5%
Total		19.1%	35.1%	28.4%	23.6%	19.5%	17.0%	13.8%	10.5%	4.4%	13.3%

Enterprise-Acquired FRMs, 2008											
		FICO Bucket									
		Missing	0 - 619.9	620 - 639.9	640 - 659.9	660 - 679.9	680 - 699.9	700 - 719.9	720 - 739.9	740 +	Total
LTV Bucket (%)	Missing	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
	0 - 59.9	2.0%	12.0%	5.9%	4.2%	2.9%	1.8%	1.3%	0.9%	0.3%	1.1%
	60 - 69.9	3.7%	18.6%	10.6%	8.0%	5.7%	4.1%	2.8%	2.1%	0.7%	2.7%
	70 - 74.9	7.3%	23.8%	14.1%	10.9%	8.2%	5.9%	4.7%	3.2%	1.1%	4.1%
	75 - 79.9	8.2%	22.1%	15.0%	11.2%	8.5%	6.8%	5.0%	3.7%	1.4%	4.0%
	80.0	1.6%	21.7%	15.0%	11.0%	8.1%	6.0%	4.5%	3.2%	1.2%	3.6%
	80.1 - 84.9	6.1%	27.4%	20.3%	18.1%	12.1%	10.0%	8.4%	6.7%	2.8%	7.6%
	85 - 89.9	1.7%	28.1%	23.1%	18.2%	14.7%	12.4%	9.1%	6.5%	3.2%	8.2%
	90.0	7.4%	31.7%	23.9%	19.5%	15.9%	12.7%	9.7%	7.2%	3.4%	8.4%
	90.1 - 94.9	5.5%	27.9%	20.4%	18.5%	12.7%	10.5%	7.0%	5.3%	2.5%	7.4%
	95 - 97.4	12.7%	33.8%	24.9%	18.4%	14.7%	11.8%	9.1%	6.6%	3.0%	8.9%
	97.5 - 104.9	23.2%	41.6%	30.9%	26.7%	20.1%	13.3%	10.2%	7.8%	4.1%	13.2%
	105 +	0.0%	23.0%	16.9%	22.4%	21.0%	11.6%	11.0%	10.5%	8.0%	11.8%
Total		5.8%	22.1%	15.9%	12.2%	9.2%	7.0%	5.0%	3.6%	1.2%	4.1%

Figure 7. Projected Foreclosures Rate in the Greater Washington DC Area

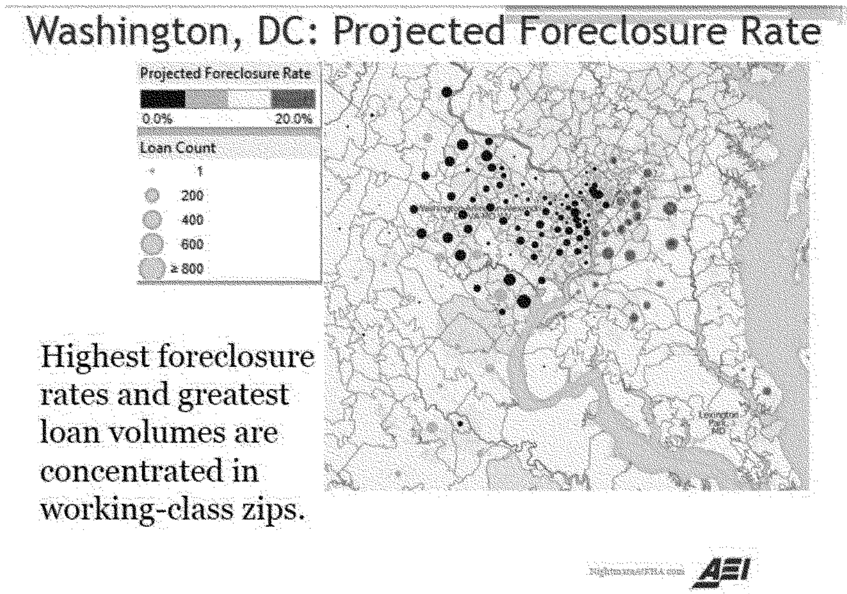


Figure 8. Conforming Loan Limits and Home Prices

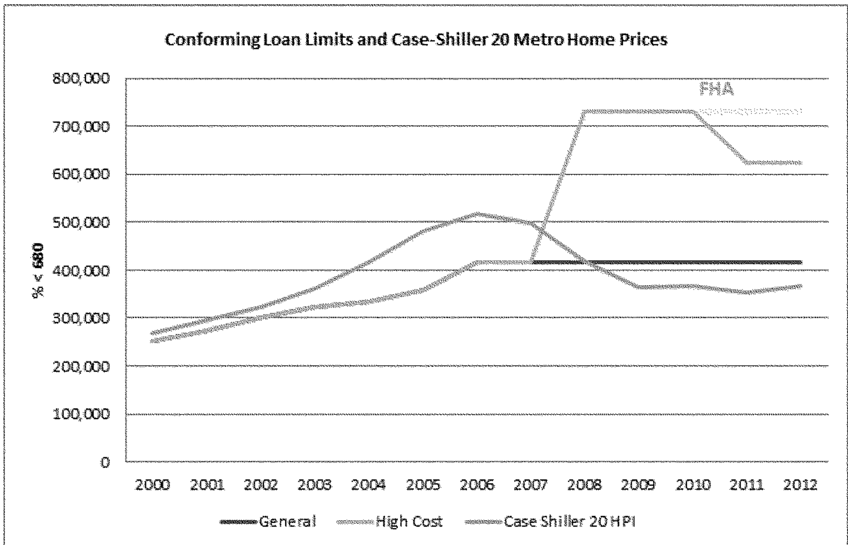
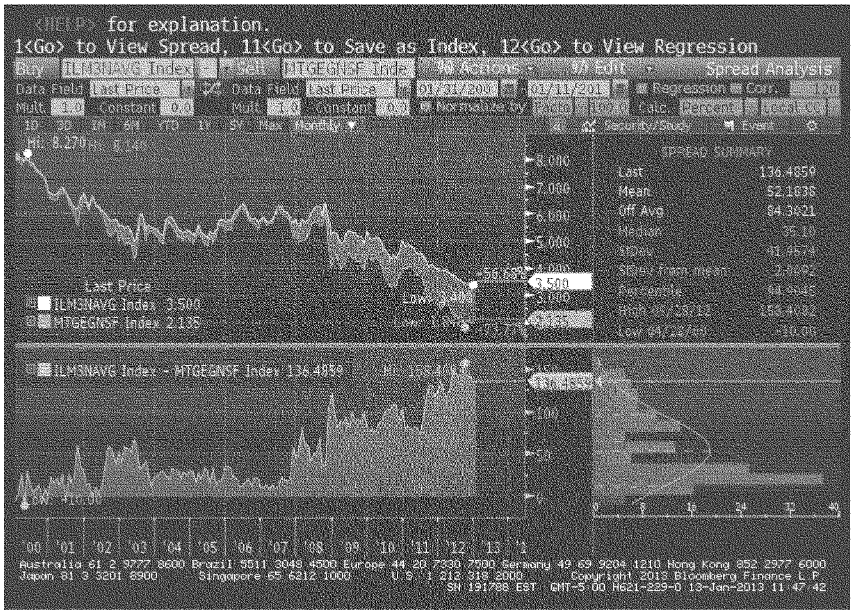


Figure 9. FHA 30 Year Mortgage Rates - Ginnie Mae 30 Year Current Coupon Rate



I. Appendix A: Summary of FHA Policy Changes under the Current Administration

1. **Changes implemented via mortgagee letter with an implementation date of January 1, 2010:**
   a. Modifications to streamline refinance documentation requirements
   b. New appraisal standards
   c. Submission of audited financial statements required for supervised lenders

2. **Mortgage insurance premium (MIP) increase and adjustments to upfront/annual MIP relationship**
   a. 1/12/2010 – Increased Upfront MIP to 2.25%
   b. 10/4/2010 –
      i. Lowered up front MIP to 1%
      ii. Raised annual MIP to 85 to 90 basis points
   c. 4/18/2011 – Increased annual MIP by 25 basis points
   d. 4/9/2012 –
      i. Increased upfront MIP from 1% to 1.75%
      ii. Increased annual MIP by 10 basis points
   e. 6/11/2012 – Increased annual MIP for loans in excess of $625,500 by 25 basis points
   f. 4/1/2013 – Increased annual MIP by 5-10 basis points, depending on loan amount and LTV.

3. **New downpayment requirements**
   a. Mortgagee Letter effective October 4, 2010
      i. Loans to borrowers with a FICO of 579 or lower require a minimum 10% downpayment
      ii. Loans to borrowers with a FICO of 580 or above require current minimum 3.5% downpayment
      iii. Minimum FICO of 500
   b. Federal Register Notice published February 6, 2013
      i. Loans to borrowers seeking loans above $625,500 require a 5% downpayment

4. **Enhanced underwriting requirements**
   a. Mortgagee Letter effective April 1, 2012
      i. Updated documentation requirements for self-employed borrowers
      ii. Offered new guidance on disputed accounts
      iii. Expanded the definition of family members for identity of interest transactions
   b. Mortgagee Letter published January 31, 2013
      i. Borrowers with credit scores below 620 and debt to income ratios over 43% subject to manual underwriting

5. **Changes to the HECM Program**
    a. Mortgagee Letter effective October 4, 2010
        i. Introduced HECM Saver, which provides a lower upfront premium (.01%) and a lower max principal limit
        ii. Increased annual MIP to 1.25%
        iii. Adjusted the HECM Principal Limit Factors, resulting in lower maximum principal limits
    b. Mortgagee Letter published January 3, 2011
        i. Provided detailed guidance regarding the property charge loss mitigation requirements for HECM loans
    c. Mortgagee Letter published January 30, 2012
        i. Consolidated Fixed Rate Standard and Fixed Rate Saver programs

6. **Increased enforcement for FHA-approved lenders**
    a. Enforcement actions taken against lenders
        i. Heightened enforcement of HUD requirements for FHA-approved lenders has yielded over:
            1. 1,780 lenders withdrawn from FHA's program as a result of violations of FHA approval, origination, or servicing requirements.
            2. Imposition of more than $14.26 million dollars in civil money penalties and administrative payments for FHA-approved lenders
        ii. Issued notice to lending community that FHA will pursue directly or through Federal partners those who advertise access to FHA, particularly after foreclosure or other credit impacting event, does not require satisfaction of all FHA loan origination and underwriting criteria
    b. Mortgagee Letter effective January 21, 2010
        i. Enhanced monitoring of lender performance and compliance with FHA guidelines and standards.
        ii. Expanded the Credit Watch Termination Initiative to include evaluation of lender underwriting performance in addition to origination performance
    c. Implementation of statutory authority through regulation of section 256 of the National Housing Act to enforce indemnification provisions for lender's using delegated insuring process
        i. Final rule published January 25, 2012, with an effective date of February 24, 2012
        ii. A Mortgagee letter and Lender Insurance guide will soon be issued to implement this new rule.
    d. Additional authority sought by FHA through legislation:
        i. Amendment of section 256 of the National Housing Act to apply indemnification provisions to all Direct Endorsement lenders. This would require all approved underwriting mortgagees to assume liability for all of the loans that they underwrite

ii. Legislative authority permitting HUD maximum flexibility to establish separate "areas" for purposes of review and termination under the Credit Watch initiative. This would provide authority to withdraw originating and underwriting approval for a lender nationwide or in a specific area on the basis of the performance of its regional branches

7. **Changes to FHA lender approval requirements**
   a. Final rule published week of April 20, 2010
      i. Increased net worth requirements for approved mortgagees. All new lender applicants for FHA programs must possess a minimum net worth of $1 million. Effective one year from enactment of the rule, current FHA approved lenders, with the exception of small businesses, must possess a minimum net worth of $1 million. Current FHA-approved small business lenders must possess a minimum net worth of $500,000. Effective three years after enactment of the rule, approved lenders and applicants to FHA single-family programs, regardless of size, must have a net worth of $1 million plus 1% of total loan volume in excess of $25 million
      ii. Eliminated independent FHA approval of mortgage brokers who originate but do not underwrite loans. FHA-approved mortgagees who underwrite loans retain strict liability for all loans, regardless of origination via their retail operations or through their sponsored mortgage brokers
      iii. Codified requirements for submission of audited financial statements by supervised mortgagees
   b. Mortgagee Letter published on January 5, 2011
      i. Required mortgagees that possess NMLS IDs to provide those to FHA for both lender approval and loan origination processes
   c. Mortgagee Letter effective July 28, 2011, provided alternative financial reporting requirements for small supervised lenders to decrease burdens associated with FHA's lender approval and renewal processes

8. **Updated Quality Control Requirements for Direct Endorsement Lenders**
   a. Mortgagee Letter effective January 5, 2011
      i. Updated FHA's quality control requirements to include new requirements related to Sponsored Third Party Originators, reporting of fraud and material deficiencies, and recording of sales or transfers of FHA mortgages

9. **Refinance Program Policy**
   a. Mortgagee Letter published February 14, 2011
      i. Extensive guidance regarding requirements and changes for FHA Standard and Streamlined refinance programs
   b. Mortgagee Letter published March 6, 2012
      i. For borrowers who are current on their loans, FHA reduced the upfront and annual MIPs for Streamline refinances of FHA-insured loans

endorsed on or before May 31, 2009 to permit these borrowers to take advantage of historically low interest rates, reducing their payments and decreasing risk to FHA

10. Consolidated and updated FHA condominium policy

a. Mortgagee Letter issued June 30, 2011, and effective August 29, 2011
    i. Consolidate guidelines published in 2009;
    ii. Provide a single source of information for the Condominium Approval and Recertification Process;
    iii. Update, consolidate and clarify existing condominium policy guidance; and
    iv. Expand FHA's flexibility to consider exceptions at the individual project level
b. Mortgagee Letter issued in summer 2012 to revise updated guidance

11. Reduction in allowable seller concessions

a. Proposed policy change published in June of 2010
    i. Received over 1,000 comments, prompting extensive additional analysis which led to substantial revisions to the rule
    ii. New proposed rule published February 23, 2012
    iii. Final Rule Expected in 2013

12. Enhanced and expanded loan sale program

a. Effective with the quarterly sale that took place in September 2012, FHA expanded the 601 Note Sales Program, now known as the Distressed Asset Stabilization Program, providing the opportunity for better outcomes for borrowers, communities and FHA on non-performing loans.

CAROLYN B. MALONEY
14TH DISTRICT, NEW YORK

2332 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515–3214
(202) 225-7944

COMMITTEES:
FINANCIAL SERVICES

OVERSIGHT AND
GOVERNMENT REFORM

JOINT ECONOMIC COMMITTEE

Congress of the United States
House of Representatives
Washington, DC 20515–3214

DISTRICT OFFICES:

☐ 1651 THIRD AVENUE
SUITE 311
NEW YORK, NY 10128
(212) 860-0606

☐ 21-77 31ST STREET
ASTORIA, NY 11105
(718) 932–1804

WEBSITE: http://maloney.house.gov

November 9, 2012

The Honorable Shaun Donovan
Secretary
U.S. Department of Housing and Urban Development
451 7th Street SW
Washington, DC 20410

Dear Secretary Donovan,

I have read several press reports over the last week concerning the health of the Mutual Mortgage Insurance Fund (MMI Fund) which included projections that the FHA may need to draw down funds from the Department of Treasury to cover expected claims over the next 30 years. Accordingly, I am writing to request information concerning the FHA's ability to cover expected losses based on the MMI Fund's current levels.

The foreclosure crisis of the last four years has put enormous stress on the housing market and its ability to recover from the losses we experienced starting in 2007. I understand that losses from loans originated between 2005 and 2008 will likely continue to be a drag on the Fund. However, the FHA insures a much larger share of the market than it did before the crisis and, as a result, several steps have been taken since 2009 to help sure up the Fund. These include increases in insurance premiums, new rules requiring higher risk borrowers to make higher down payments and efforts to mitigate losses on delinquent loans. The FHA has also reportedly recovered approximately $900 million as part of the mortgage servicing settlement. These actions will likely bolster the agency's reserves, however, I believe it is important to know whether they will ward off the need for temporary support from the U.S. Treasury.

I am hoping you can provide my office information about the capital reserves in the MMI Fund which are dangerously low and only slightly above the 2% level that is required by law. Specifically, to what extent are you concerned that the Fund is operating so close to the 2% level? In addition, what is the likelihood that FHA will need to access funds from the U.S. Treasury and what additional steps will the FHA take to ensure it does not need to access those funds? Finally, please advise my office as to the efforts by the FHA to enforce the rules that are designed to stem foreclosures and decrease further losses.

Thank you for your assistance with this request. I look forward to working with you to address the housing crisis that has been holding back economic growth in our country.

Sincerely,

Carolyn B. Maloney

CAROLYN B. MALONEY
Member of Congress

LISC
Helping neighbors
build communities

February 5, 2013

The Honorable Jeb Hensarling
Chairman, House Financial Services Committee
U.S. House of Representatives
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member, House Financial Services Committee
U.S. House of Representatives
Washington, DC 20515

RE: February 6, 2013 House Financial Services Committee Hearing on "The Role of the Federal Housing Administration in Housing Finance"

Dear Chairman Hensarling and Ranking Member Waters:

Thank you for the opportunity to comment on role of the Federal Housing Administration (FHA) in financing the nation's homeownership. This is an important topic regarding an essential element of our communities' stability and that of the entire economy.

The Local Initiatives Support Corporation (LISC) is dedicated to helping community residents transform distressed neighborhoods into healthy and sustainable communities of choice and opportunity — good places to work, do business and raise children. LISC mobilizes corporate, government and philanthropic support to provide local community development organizations with financial, technical and policy resources. We are a national organization with a community focus, with local LISC offices in 30 different cities and partnerships with a network of 60 rural organizations. Our program staff in the cities and the rural areas where we work collaborate actively with local community development groups, to help identify priorities and challenges, and to deliver the most appropriate support to meet local needs – whether it's in the area of housing, economic development, education, healthcare, community safety, or building family income and wealth.

Our perspective on FHA is based on our long history of supporting urban and rural homeownership in the communities we serve. We have supported the creation of over 30,000 units for single-family homeownership and recognize the importance of this stock to our communities. We have seen the best and the worst of how the housing finance system affect low-income metropolitan and rural communities and their residents.

Our message today is basically that while lessons are still being learned from the effects of the Great Recession on the FHA, and vice versa, we continue to have confidence in the FHA and the ongoing importance of its mission.

LOCAL INITIATIVES SUPPORT CORPORATION
1825 K Street, NW, Suite 1100 ▪ Washington, DC 20006 ▪ Phone 202.785.2908 ▪ Fax 202.835.8931
WWW.LISC.ORG

In our March 23, 2010 testimony to this Committee, we stated that an important lesson from the recent historic downturn is that the long-term interests of consumers and lenders, and of communities and the financial system, are and must fundamentally align rather than conflict. Further, we must ensure that all communities and their residents are included within the financial mainstream, consistent with safety and soundness. Anything less would only undermine opportunity and prosperity. Many of the problems of the recent past resulted when short-term expediencies in the private market unfortunately overtook long-term prudence. The resulting collapse of private home mortgage financing underscores the significance of the FHA as a public anchor for community sustainability.

We also stressed that:

- FHA (as well as private capital markets that are aggregated through any future GSE structure) should provide low- and moderate-income people with full and equitable access to mainstream capital markets.
- Capital access for all communities, including economically distressed, low-income, rural, and minority communities, on a fair, equitable and sustainable basis, is essential to the economic and social viability of these communities.
- Liquidity is necessary in all economic conditions, and FHA is an essential part of ensuring that continuity.

We do not address here differing interpretations of the FHA's safety and soundness in the wake of the recent GAO report, except to note that, despite a negative capital ratio at this time, the Fund is not illiquid. Further, HUD projects material improvements in the Fund's capital position in 2013.

The FHA mortgage insurance fund serves several critical purposes:

It is a countercyclical anchor to spatial, temporal and credit risk weaknesses. Even as its market share decreases towards more historically typical levels, this role will remain important, as the housing finance system undergoes further transformation and while major demographic shifts play out.

Rather than crowding out private lending activity, FHA has provided a stable and responsible source of mortgage lending capital after the collapse of the market for private originations. This has helped to prevent further price deterioration and loss of credit availability, especially in hard-hit locations. Arguably, this stability has also protected the nation against another recession.

Although the delinquency rate on FHA-insured loans increased to over 25 percent on loans originated in 2007 and 2008, that rate has dropped substantially and FHA's overall delinquency rate today remains healthier than that of subprime fixed-rate mortgages, and both prime and subprime Adjustable Rate Mortgages (ARMs).

The full faith and credit of the federal government has been an important component of the FHA's ability to provide this stability, and any proposals to modify this policy should be carefully assessed to avoid unintended consequences that could include loss of FHA's ability to fill the gaps it was intended to address.

The Fund also provides access to credit for homeowners with a wide range of economic circumstances. Low down payments remain an essential component of access to homeownership for families of limited means. This does not mean that FHA's underwriting is unsound. In fact, even as subprime default rates soared to over 30 percent during the downturn, FHA default rates were less than half that level.

The FHA has been a leader in innovation and standardization. The 30 year fixed-rate mortgage, GNMA securitization of FHA-insured mortgages, and research leading to the development of credit scoring are examples of instances in which the FHA has led the way in developing new industry standards. The Administration's HUD team combines innovation with prudence in the administration of FHA. We recognize that some product features have contributed to Fund losses, such as seller-financed down payments. However, HUD made attempts to curb this practice, and the Housing and Economic Recovery Act of 2008 (HERA) finally prohibited it. The essential public purpose of responsible FHA innovation should be encouraged and continued.

We believe that a healthy housing market is necessary not only to meet household shelter needs, but also to support the economy as a whole. FHA has a key role in that market, and its continued flexible administration should be commended and continued, even as we work together to seek continued improvements.

LISC commends Chairman Hensarling and Ranking Member Waters for bringing attention to the role of the FHA and the importance of the FHA Insurance Fund. We look forward to working with you on any efforts designed to promote affordable housing solutions. For further information, please contact Barbara Burnham, Vice President for Federal Policy, at 202-739-0896 or bburnham@lisc.org.

Sincerely,

Vincent O'Donnell
Vice President, Affordable Housing Preservation Initiative

Statement of the National Association of Home Builders

Hearing on

"The Role of the Federal Housing Administration in Housing Finance"

House Committee on Financial Services

February 6, 2013

Introduction

The National Association of Home Builders (NAHB) appreciates the opportunity to submit a statement in support of the single family and multifamily mortgage insurance programs of the Federal Housing Administration (FHA). NAHB represents over 140,000 members who are involved in building single family and multifamily housing, remodeling, and other aspects of residential and light commercial construction. NAHB's builder members construct approximately 80 percent of all new housing in America each year, and many of our builders rely on the use of the programs of the Department of Housing and Urban Development (HUD) (largely FHA's) in order to help provide decent, safe, and affordable housing to many of our fellow citizens.

NAHB supports efforts to reform FHA, and we understand that this is not a simple undertaking, yet we want reform to be approached with a certain degree of caution. Reform of these programs cannot be separated from the larger discussion of reforming the complex housing finance system, including future reforms to Fannie Mae and Freddie Mac. While the recent FHA actuarial report is troubling, and certainly deserving of congressional oversight, NAHB urges Congress to proceed cautiously and not significantly alter the structure or role of FHA programs.

The FHA was created in 1934 during the Great Depression to promote stability in the housing marketplace and has been viewed as a housing finance innovator by insuring millions of mortgage loans since its inception. In its nearly 80 year history, the agency has successfully achieved its mission at no cost to taxpayers. The fact that the FHA finds itself in this position now, as opposed to four years ago during the height of the financial meltdown, is testament to its ability to meet its mission in these difficult economic times.

While there is no doubt that the housing finance system needs to be reformed, the contributions that the FHA has made during this economic downturn underscore the need for a government backstop for both the primary and secondary mortgage markets. In times of crisis, private financial institutions have been unable or unwilling to meet housing capital needs. Without government support for home purchasing and refinancing, the nation's mortgage markets will grind to a halt in times of economic stress and uncertainty, throwing the economy back into recession.

Given the significant role that housing plays in the economy, Congress needs to take a long-term, holistic approach to housing finance reform. NAHB stands ready to work with the House Financial Services Committee to achieve such reforms and provide much-needed stability for this critical sector of the economy.

Importance of the Federal Housing Administration for Single Family and Multifamily Mortgage Financing

Since the creation of the FHA, it has had a long track record of achievement in insuring loans for over 37 million American families, many of whom would not otherwise have been able to own a home. FHA pioneered the concept of a 30 year fixed-rate mortgage and low down payments, and the nation still benefits from that program today. FHA maintains strong underwriting criteria to protect the tax payers and is intended to be self-funded through the upfront and annual mortgage insurance premiums that borrowers pay.

Contrary to the belief of some, FHA is not a subprime lender and has never required a federal bailout. Although the single family mortgage insurance program is experiencing shortfalls in its excess reserves due to the effects of the worst economic downturn since the Great Depression, FHA remains an integral part of our nation's economic recovery. Housing has led America out of every economic downturn and can do so again if the future policies regarding housing finance reform are addressed in a manner that provides liquidity for the entire housing sector in all markets.

Looking at the dramatic increase of FHA's market share of single-family mortgages over the past few years, it is clear how essential the program is for our nation's economic recovery. Since the downturn in the housing market, FHA has become the primary source of mortgage credit for first-time home buyers, minorities and those with limited downpayment capabilities as other sources of mortgage credit have disappeared. During this time, FHA's share of the market jumped from 3 percent during the housing boom to a high of almost 30 percent early in the crisis. Nearly 80 percent of FHA's purchase loans have been to first-time home buyers. This dramatic shift is evidence that FHA is performing its mission of providing the federal backstop to ensure that every American has access to a stable mortgage product. While NAHB believes that the private market should be the primary source of mortgage financing, that market is extremely limited; until it returns, FHA and other federally backed programs are needed to keep our economy afloat.

FHA historically also has played an important role in the financing of multifamily rental housing, and it is especially important now during the current economic crisis. In 2008, FHA endorsed just over $2 billion in multifamily loans (excluding health care programs), which grew to $14.6 billion in FY2012. The FHA multifamily mortgage insurance programs are fulfilling the function and mission for which Congress originally intended.

FHA Single Family Mortgage Insurance Programs

The FHA single-family mortgage programs are a unique and vital component of the housing finance system, providing access to homeownership for underserved communities, primarily first-time homebuyers, minorities and those with limited downpayment capabilities. During the recent mortgage crisis FHA demonstrated how invaluable their counter-cyclical role was in providing mortgage market liquidity during the country's unstable housing market system. This role has not been without costs to the FHA program as evidenced by the recent actuarial studies of the FHA's Mutual Mortgage Insurance Fund (MMIF).

FHA has implemented a series of policy changes over the last couple of years, including higher mortgage insurance premiums, tighter underwriting requirements, stricter mortgage lender enforcement, and improved risk assessment all intended to strengthen the performance of the Mutual Mortgage Insurance Fund (MMIF) and rebuild the capital reserve ratio. These changes are the most sweeping combination of reforms to credit policy, risk management, and lender enforcement in FHA history.

NAHB generally has been supportive of FHA's changes to bolster the MMIF. However, NAHB strongly believes that such changes must be balanced to ensure the ability of FHA to maintain its critical mission of providing support for homebuyers.

FHA reform must modernize FHA's operations allowing the agency to operate more efficiently and effectively. FHA should be provided the necessary tools that reflect its importance to housing finance. Reform must be implemented in a structured process to ensure access to responsible credit and support for home buyers during this tenuous juncture in the economic recovery.

FHA Multifamily Mortgage Insurance Programs

NAHB has long-supported the FHA multifamily mortgage insurance programs. These programs, notably Section 221(d)(4) and Section 223(f), have enabled the construction of needed affordable and market rate rental housing units over the years, as well as contributed to the ability of property owners to acquire, refinance, rehabilitate and preserve the nation's existing stock of rental housing. Of importance, FHA financing is often used in smaller markets where the government-sponsored enterprises (GSEs) and other market participants are less active, and FHA has filled the niche that local banks and thrifts have retreated from in recent years.

It is important to note that over the last two years, HUD has instituted new risk management protocols for the FHA multifamily mortgage insurance programs. The new protocols tightened underwriting requirements and created a national loan review committee. New policies were implemented for large loans, including higher standards for sponsor creditworthiness and experience. Processes and procedures throughout the field offices have been strengthened and standardized. There is closer scrutiny on market strength and FHA presence than before the economic crisis struck.

In addition, HUD revised and tightened lender capitalization, licensing and monitoring requirements, made significant changes as part of the update of the loan closing documents, and finalized several changes to the multifamily mortgage insurance program regulations. The most recent step taken was raising the mortgage insurance premiums for programs in the General Insurance/Special Risk Insurance fund (GI/SRI). This was the first premium increase in 10 years for these programs.

All of these actions were intended to strengthen risk management practices related to the FHA multifamily mortgage insurance programs, ensure the health of the GI/SRI fund, and attract high quality borrowers, without taking market share from the private sector or endangering taxpayers. NAHB has been actively engaged in working with the department as these requirements have been implemented. Although NAHB has not agreed with every action taken, overall we have supported HUD's objectives and have worked to ensure that borrowers and lenders understand the changes.

Conclusion

Few things are more important to Americans than their homes. Whether they rent or own, Americans want to choose where they live and the type of home that best meets their needs. Rental housing is the choice for millions, from all ages and walks of life. For many others, the opportunity to own a home is the cherished ideal. Today, even though the housing market is still suffering from the effects of the worst housing market downturn since the Great Depression, Americans still believe in homeownership, which is why NAHB appreciates the key role FHA has played in keeping our housing market liquid, stable and affordable.

Given the significant role that housing plays in the economy, we urge Congress to take a long-term, holistic approach to housing finance reform. NAHB stands ready to work with you to achieve such reforms and provide much-needed stability for this critical sector of the economy.

NCLR
NATIONAL COUNCIL OF LA RAZA

FHA REFORM FOR TOMORROW'S LATINO HOMEOWNER

Statement for the Record

"Examining the Proper Role of the Federal Housing Administration in our Mortgage Insurance Market"

Submitted to

The Committee on Financial Services

Submitted by

Janet Murguía
President and CEO
National Council of La Raza

February 6, 2013

On behalf of NCLR (the National Council of La Raza), please accept this statement for the record in response to the hearing entitled "Examining the Proper Role of the Federal Housing Administration in our Mortgage Insurance Market." NCLR is the largest national Hispanic civil rights and advocacy organization in the United States. It has been committed to improving opportunities for the nation's millions of Latinos since 1968. To this end, NCLR conducts research, policy analysis, and advocacy on a variety of financial services issues that impact the ability of Latinos to build and maintain assets and wealth. NCLR thanks Chairman Hensarling and Ranking Member Waters for the opportunity to share our perspective on the role of the Federal Housing Administration (FHA).

NCLR is uniquely positioned to understand FHA's role. For more than 20 years, we have worked in the community development field on behalf of low-income families. Through its more than 50 HUD-certified community-based providers, the NCLR Homeownership Network (NHN) provides first-time homebuyer and foreclosure prevention counseling to more than 60,000 families a year. NHN counselors work closely with FHA borrowers to ensure that they are prepared for homeownership and to help them avoid foreclosure and predatory scams.

FHA has long provided essential mortgage credit to first-time homebuyers and it is critical that this American institution is strengthened and not abandoned or allowed to dwindle, especially in today's economy. In this statement, NCLR highlights three important areas to strengthen FHA.

1. **FHA is a lifeline for many families throughout the United States.** It has long provided safe and sound baseline products to Latinos and has filled a unique role with proven success that no other entity often fills. While FHA insurance was used for approximately 27% of all home purchase mortgages in 2011, FHA accounted for 50% of home purchase mortgages for Black borrowers and 49% for Hispanic borrowers. It is vital that such programs continue to ensure that a fair product is accessible and affordable to those working to move into the middle-class.

2. **FHA must be modernized with a focus on mitigating abuse and fraud.** The federal government is obligated to promote nondiscrimination, residential integration, and equal access to the benefits of decent and safe housing and ownership opportunities. However, clear standards for implementation have not been applied to our housing finance system. This lack of clarity has opened the door for a persisting dual credit system—that is, a two-tiered financial system. Communities of color, the elderly, and women borrowers have been routinely steered into substandard mortgages, even when their credit warranted a prime loan. Such loans are more expensive and more likely to go into foreclosure, costing Black and Latino families alone billions of dollars in lost wealth. The dual credit market is a real challenge but FHA can be part of the solution through modernization. In addition, much of the unexpected spikes in FHA delinquencies can be attributed to imprudent originator behaviors or economic conditions rather than the design of the FHA loan product. In fact, according to the FHA's *Annual Management Report: Fiscal Year 2009*, had loans not been made using seller down payment assistance programs, known for being fraught with fraud and abuse, its capital reserve ratio would still be at the recommended 2%. Limited program oversight has opened the door to a variety of abuses, including inflated appraisals, property flipping, and other fraudulent or sloppy

origination practices. These challenges can be overcome with a resolve to modernize FHA's standards and framework.

3. **FHA must not arbitrarily stifle credit access.** FHA is well positioned to generate healthy competition in segments of the housing market but it mustn't tighten credit as a knee-jerk response to the housing crisis. Indeed, it must fine-tune its processes but not overshoot with restrictive credit for the sake of restricting credit. When fully functioning, FHA can serve as the "conscience of the market." Government-backed entities like FHA emerged as the dominant providers of housing credit while private capital fled the market. Analysts, decision-makers, and media pundits pointed fingers at government programs but they were not to blame. While FHA is in need of reform, it must not relinquish a pillar in its mission for which it was created and has appreciated vast success historically.

Looking toward effective reform of the housing market, FHA and like entities must keep in mind the new characteristics of the millions of current homeowners affected by the crisis and the makeup of future homeowners throughout the nation. Latinos are projected to account for nearly 50% of new households formed in 2010–20, suggesting that a failure to incorporate the needs of Hispanics and other communities of color into the nation's federal housing policy will have negative consequences for all. FHA continues to provide a critical platform through which Congress and the administration can directly help families rebuild their financial future. Nationwide, millions of families are relying on FHA to help them purchase their first home or avoid foreclosure. As the housing finance system proceeds toward much needed reform and modernization, we must not disregard FHA's nearly 80 years of positive influence on building up the middle class. Before the creation of such critical government programs, our families had few to no options. The benefits of a government-supported housing finance system should be broadly available to all creditworthy borrowers, not channeled just to the affluent segments. We know from experience that left to its own devices, the market will deliver these benefits where it is easiest to do so and where the profit margins are highest. Such cherry-picking practices result in the benefits flowing primarily to private shareholders and to the narrow group of borrowers who least need them as opposed to the economy as a whole. Rather than clipping FHA's wings, the government should lead the market in safe and sound innovation to embrace the future homebuyer.

POTOMAC PARTNERS LLC
The Power of Partnership in Washington

Statement of Brian Chappelle
Partner, Potomac Partners LLC
Washington D.C.

Hearing before the U.S. House of Representatives
Committee on Financial Services
on
"Examining The Proper Role of the Federal Housing Administration in Our Mortgage Insurance Market"

Wednesday, February 6, 2013

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to submit this statement on the proper role of the Federal Housing Administration.

At its core, FHA is an insurance company. Like any private insurer, FHA must be able to spread its risk. Just like an automobile insurer cannot be limited to drivers under the age of 25, FHA should not be limited to loans that have higher risk characteristics. Doing so would either require FHA to raise premiums significantly on borrowers who can least afford them or require taxpayer assistance. Neither is an attractive option.

FHA has an even more daunting task than your typical insurer. Its dual mission is:

1) To serve borrowers not adequately served by the private sector
2) To operate at no expense to the American taxpayer.

As a former Division Director in the Office of Single Family at FHA during the mid-1980's, I saw first-hand how FHA carried out its mission by backstopping the housing market in the "oil patch" states after the private sector pulled back when the economies in these states weakened and house prices dropped. Much like FHA has done for the entire country after the housing market collapsed in 2007, FHA played an instrumental role in the supporting the housing market in these states.

FHA incurred steep losses in those markets that ultimately resulted in the 1990 FHA reform legislation that raised insurance premiums and increased downpayments. However, as the Fund recovered more quickly than was projected, both downpayments and insurance premiums were lowered in 1992 (and premiums were lowered three more times in the 1990s) and the Fund exceeded the newly mandated 2 percent capital ratio by 1995.

As the Committee looks into the appropriate role for the FHA in light of its current challenges, I encourage the members to consider the very favorable FHA performance data that is discussed below. Afterwards, I offer some perspectives on FHA's role in the mortgage market going forward.

The main points of my statement are:

- **FHA's recent originations (FY 2010 -2012), which comprise 58% of FHA's portfolio, are performing better than in any three-year period in more than 30 years.**

  This record low claim rate has been projected even though the FY 2012 audit includes over $28 billion of negative adjustments.

- **FHA's credit quality has improved dramatically since the housing crisis.**

  FHA is insuring a record high percentage of loans with higher credit scores (680 & above).
  - Over 50 percent of FHA's fully underwritten loans insured since FY 2009 have credit scores of 680 and above. Only 22% of FHA's loans in FY 2005 - FY 2008 had credit scores of this level.

  FHA is insuring many fewer loans with lower credit scores (below 620).
  - Less than 7% of FHA's volume since FY 2009 has credit scores below 620. 38% of FHA's volume in FY 2005 - FY 2008 had credit scores under 620.

    FHA's March 2010 Congressional testimony documented the correlation between credit quality and loan performance. The testimony stated:

    "FHA low downpayment loans (LTVs above 95% with credit scores of 680 and above perform better than loans with 10% downpayment and credit scores between 620-679."

- **Congress has already addressed FHA's primary problem when it terminated the seller funded downpayment assistance (SFDPA) loan program in September 2008.**

  The FY 2012 actuarial review estimates that SFDPA loans have cost the Fund over $15 billion. These loans are now only 4 percent of FHA's portfolio.

- **FHA leadership has moved to strengthen the insurance fund by increasing insurance premiums, tightening underwriting requirements, expanding quality control activities, and more aggressively enforcing lender performance standards to remove poor performing lenders.**

  Starting in August 2009 when FHA terminated one of the largest FHA lenders (Taylor, Bean & Whitaker), FHA sent a clear message to the industry that it will not tolerate unacceptable lending practices.

- **The fundamental problem with the mortgage market today is not that FHA is making too many purchase loans, but that the total purchase mortgage market is not making enough loans.**

  FHA's FY 2012 purchase volume is now 13 percent below FHA purchase activity in FY 2000 when FHA's share was in line with historical norms. FHA purchase activity has fallen steadily since FY 2010 and its FY 2012 volume of 733,864 purchase loans is now 34 percent below FY 2010 levels when FHA insured 1.1 million purchase loans.

  Home Mortgage Disclosure Act (HMDA) data shows that U.S. total purchase transactions have almost declined 50 percent from 4.79 million loans in 2000 to 2.42 million loans in 2011 (latest year available).

Add it all up and the mortgage market and the broader economy would be in much worse shape without FHA's involvement. More important to this discussion, the FHA Mutual Mortgage Insurance Fund would be in far worse financial condition without the loans FHA has made since the housing market collapsed.

That being said, no one can dispute that FHA has incurred significant losses in the last several years. The sharp decline in home prices and the recession hurt many homeowners regardless of the type of financing. Home prices have fallen over 30% from their peak in 2006 according to S&P/Case-Shiller home price data. The impact of this decline, coupled with the weak economy, affected many homeowners.

In a February 2012 speech, Federal Reserve Chairman Bernanke said the following about the adverse affect of the housing crisis on prime mortgages:

> "an increasing share of losses have arisen from prime mortgages that were originally fully documented with significant downpayments, but that have defaulted due to the weak economy and housing market."

If prime mortgages with "significant downpayments" have defaulted, it was inevitable that FHA mortgages with much smaller downpayments would face even greater challenges in light of the Nation's housing and broader economic problems.

In assessing FHA's role, the critical question is:

> "Are FHA's recent financial problems caused by systemic issues in the program (e.g. low downpayment), or are they the result of a unique event (i.e. worst recession since the Depression)?"

FHA performance data and the FY 2012 actuarial review prepared by an independent auditor support the conclusion that FHA's problems are not systemic in nature, but rather are the result of a unique event (i.e. the recession) since there is a sharp dichotomy in the performance of older and newer books of FHA business. FHA's problems are concentrated in its older books tied to the worst recession since the Depression and the SFDPA program that Congress terminated more than four years ago.

These points are discussed in greater detail below.

I. FHA Mortgage Performance

Both the FY 2012 Actuarial Review and FHA performance data underscore the dramatic improvement in FHA loan performance since the housing crisis.

<u>FY 2012 Actuarial Review</u>

While the audit's headline number of negative $13.48 billion (for the FHA forward program) raises questions about the solvency of the Fund, a closer look at the independent actuary's analysis confirms that FHA's problems are concentrated in older books (primarily FY 2005 – FY 2008 originations) and that recent books (FY 2010 - FY 2012) are performing better than any three-year period of FHA loans in more than 30 years.

Below is a chart documenting the projected cumulative claim rates for these books.

FY 2010 – FY 2012 Books
Projected Cumulative (Lifetime) Claim Rate
FY 2010 – FY 2012 Actuarial Reviews

Actuarial Review	Cumulative Claim Rate
FY 2010	7.8%
FY 2011	7.2%
FY 2012	6.3%

The combined cumulative claim rate for the FY 2010 -2012 books has fallen steadily in the last three audits and the FY 2012 audit projects a 19 percent decline in the combined claim rate for these books compared to the projections in the FY 2010 audit. This improved claim rate translates into over 60,000 fewer claims for these books.

These books would be performing even better if streamline refinance loans (with higher risk characteristics from the original loans) were excluded from this analysis. FHA permits loans already insured to be "streamlined" to lower the interest rate on the original loan. While these "streamline" actions help the homeowner and reduce risk for the portfolio, they do have the effect of making newer books look worse then they really are. (See the Appendix for the impact of FHA streamline refinance loans on recent books.)

FHA's Performance Problems Are Intensifying In Older Books of Business

The combined cumulative claim rate for the FY 2005 – FY 2008 books has increased steadily in the last three audits.

Below is a chart documenting the projected performance data for the FY 2005 – FY 2008 books.

FY 2005 – FY 2008 Books
Projected Cumulative (Lifetime) Claim Rate
FY 2010 – FY 2012 Actuarial Reviews

Actuarial Review	Cumulative Claim Rate
FY 2010	17.1%
FY 2011	21.3%
FY 2012	25.2%

The FY 2012 audit now projects a 47 percent increase in the combined cumulative claim rate for these books compared with the 2010 audit. This deterioration in the combined claim rate means another 185,000 claims are projected for these older books in the FY 2012 audit compared with the FY 2010 study. These four books are only 13 percent of FHA's portfolio.

To summarize, while the projections about the FHA Fund's ability to cover future losses keep getting worse, the audit also shows that the performance of new FHA loans (FY 2010 – FY 2012 books), which comprise 58 percent of its portfolio, keeps getting better. In fact, the combined cumulative claim rate for the FY 2010 – FY 2012 books is now four times lower than the rate for FY 2005 – FY 2008 books.

FHA Mortgage Data

FHA performance data has also improving significantly.

FHA's early period delinquency rate has declined significantly for loans insured since FY 2009 as compared to loans insured in FY 2007 & FY 2008.

Early period delinquency measures performance (seriously delinquent) within the first six payments. This is the first indicator of the quality of new books of business. High early period delinquency rates are indicative of possible fraud, poor underwriting and generally poor loan quality (e.g. seller funded downpayment assistance loans).

The following chart breaks out the early period delinquency performance of FHA activity for FY 2007 – FY 2011. In addition, as will be discussed later in this statement, FHA's credit quality improved significantly during FY 2009. Accordingly, to examine the impact of this change in credit quality, subtotals are also provided for FY 2007 – FY 2008 and for FY 2009 and later.

Early Period Delinquency (EPD) Rates by Origination Year

Fiscal Year	Early Period Delinquencies	Total Originations	Early Period Delinquency (EPD) Rate
2007	8,811	402,343	2.19%
2008	20,637	1,031,584	2.00%
2007 & 2008 Subtotal	**29,448**	**1,433,927**	**2.05%**
2009	19,462	1,831,312	1.06%
2010	7,252	1,666,886	.44%
2011	4,165	1,196,606	.35%
2009 & later Subtotal	**30,879**	**4,694,804**	**.66%**

*HUD Quarterly Reports to Congress

The early period delinquency rate has dropped sharply since FY 2007 – FY 2008. The FY 2009 – FY 2011 books performed 67% better than the FY 2007 - FY 2008 books. While not included in the chart, FHA's FY 2009 – FY 2011 books also had a 42% lower EPD rate than the FY 2004 and FY 2005 books, which had a combined early period delinquency rate of 1.17%. FHA's FY 2005 – FY 2008 books account for about 15% of its portfolio.

FY 2009 was a transitional year in FHA performance.

The chart above also points out the significant improvement that occurred during FY 2009 and then in FY 2010 and FY 2011. FHA's FY 2009 EPD rate was almost 50% better than the FY 2007 – FY 2008 rate, and the FY 2010 – FY 2011 EPD rate is 50% better than FY 2009. The combined FY 2010 - FY 2011 books performed five times better than the FY 2007 - FY 2008 books.

The following chart shows the quarterly breakdown for FY 2009 early period delinquency rates with subtotals for the first two quarters and the last two quarters of the fiscal year.

FY 2009 Early Period Delinquency Data By Quarter

2009 Fiscal Year Quarter	**Early Period Delinquencies**	**Total Originations**	**Early Period Delinquency Rate**
1	5,849	409,025	1.43%
2	5,045	400,424	1.26%
Subtotal (Q1 & Q2)	**10,894**	**809,449**	**1.35%**
3	4,956	490,646	1.01%
4	3,612	531,217	.68%
Subtotal (Q3 & Q4)	**8,568**	**1,021,863**	**.84%**

There was steady improvement in FHA's early period delinquency rate for each quarter of FY 2009. The early period delinquency rate for the last two quarters of FY 2009 is 38% below the rate for the first half of FY 2009. Moreover, although the FHA volume increased more than 25% in the second half of the fiscal year, the number of early delinquencies declined 20 percent.

The continued improvement reflects the higher quality FHA originations that were insured later in 2009. Congress terminated the seller funded downpayment assistance program in August 2008 and affected loans had to be closed by September 30th to be eligible for FHA insurance. Some loans were not insured until FY 2009 (approximately 40,000 loans).

Another reason for better loan quality in FY 2009 is that lenders expanded their own credit overlays (underwriting restrictions) in addition to FHA requirements. These overlays demonstrate that lenders have been concerned about their liability in the FHA program. FHA also took several high profile enforcement actions in 2009 that reinforced the industry's concern about their potential risk in the program.

The performance of FHA's loans originated in the last two years is excellent.

FHA's Neighborhood Watch system presents another view of early loan performance. It provides a snapshot of the performance of FHA loans originated in the most recent two-year period as of a particular point in time. Neighborhood Watch was implemented in 1999. The following chart displays seriously delinquent data for loans originated in the most recent two years as of the end of each calendar year from 2005 - 2011. (August is the latest available period in 2012 since HUD removed streamline refinance transactions in September.) (Link to Neighborhood Watch - https://entp.hud.gov/sfnw/public/)

For example, for the two-year period ending December 2005, it includes the early default performance of FHA originations in 2004 and 2005 as of December 31, 2005. For the two-year period ending December 2011, it includes the early default performance of originations for 2010 and 2011 as of December 31, 2011 and so on.

The following chart includes total FHA originations for the two-year periods, the number of seriously delinquent (S/D) loans and the percentage of seriously delinquent loans originated in each of the two-year periods.

Performance of FHA Loans Originated in Two-Year Periods By Calendar Year End Date

Two year period year ending	S/D Loans	Total FHA Loans for last two years	% of FHA Loans originated in two-period that are S/D
Dec 2005	41,516	1,161,710	3.57%
Dec 2006	28,362	860,627	3.30%
Dec 2007	35,373	864,323	4.09%
Dec 2008	77,019	1,788,355	4.31%
Dec 2009	162,149	3,212,363	5.05%
Dec 2010	96,953	3,430,615	2.83%
Dec 2011	47,180	2,546,532	1.85%
August 2012*	32,642	2,358,646	1.38%

- FHA changed criteria in September to remove streamline refinances. To ensure consistency, August 2012 data is used.

FHA's seriously delinquent rate for loans originated in the most recent two years (1.38%) is at the lowest rate in the 13-year history of the Neighborhood Watch system. It has declined 73% since it peaked in December 2009. There are now fewer seriously delinquent loans than there were in December 2005, even though FHA's volume for the two-year period ending April 2012 was more than double the December 2005 volume.

This improving rate has also occurred even though FHA's volume in the two-year period has declined 31% since December 2010. This means, on a relative basis, that there were more seasoned loans in the August 2012 period than in December 2010 making the record low seriously delinquent rate even more impressive.

II. FHA credit quality has improved markedly since the mortgage market collapsed.

When the subprime mortgage market collapsed in 2007, there was widespread concern that the FHA program would be flooded with subprime loans. Below is a chart that provides the number and percentage of FHA loans for each fiscal year from FY 2005 to FY 2011 broken down by two major credit score risk categories (i.e. loans with credit scores of 680 and above and loans with credit scores below 620). These breakouts represent the cut points for low risk and high-risk loans in the FHA portfolio.

FHA Activity By Key Credit Score Tranches

Fiscal Year	Credit Scores ≥ 680		Credit Scores < 620	
	# of loans	% of total	# of loans	% of Total
2005	84,000	23%	142,000	39%
2006	87,000	24%	138,000	44%
2007	77,000	20%	169,000	44%
2008	273,000	28%	333,000	34%
2009	710,000	47%	215,000	14%
2010	829,000	57%	56,000	4%
2011	607,000	60%	29,000	3%
2012	554,000	57%	29,000	3%

FHA has experienced a remarkable turnaround in the credit characteristics of recent originations. FHA credit quality has improved steadily since its volume began increasing in 2008. In FY 2005 – FY 2008, there were more loans with credit scores below 620 (782,000 loans) than there were loans with credit scores of 680 and above (521,000 loans). In fact, in FY 2005 – FY 2007, there were almost twice as many loans with credit scores below 620 as there were loans with credit scores of 680 and above.

Starting in FY 2009, that trend has been completely reversed. FHA has insured over 2.7 million loans with credit scores of 680 and above and only 329,000 loans with credit scores under 620, of which 67% were insured in FY 2009. In addition to the elimination of the seller funded downpayment assistance program, there was also an appreciable increase in FHA credit quality. Below is a chart that breaks down FHA's FY 2009 quarterly data by the same credit score risk categories for low risk (680 and above) and high risk (below 620).

FHA FY 2009 Activity By Key Credit Score Tranches*

Fiscal Year	Credit Scores ≥ 680		Credit Scores < 620	
2009	# of loans	% of total	# of loans	% of Total
1Q	148,000	38%	94,000	24%
2Q	136,000	43%	59,000	19%
3Q	182,000	51%	36,000	10%
4Q	244,000	56%	26,000	6%

In FY 2009, the loans with credit scores of 680 and above jumped 65% from the first to the fourth quarter and the loans with credit scores below 620 fell almost 75% during the same period.

Importance of credit score on FHA loan performance

FHA loans with higher credit scores perform much better than loans with lower scores even with higher downpayments. For example, FHA loans with credit scores of 680 and above and low downpayments (LTVs above 95%) perform better than loans with 10% downpayments and credit scores between 620-679.

Below is an excerpt from FHA's March 2010 testimony on the importance of credit scores in the FHA program.

> "Furthermore, downpayment alone is not the only factor that influences loan performance. The combination of downpayment and FICO score is a much better predictor of loan performance than just one of those components alone." (See the following chart.)

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

III. Congress has addressed the significant problem when it terminated the seller funded downpayment assistance program in September 2008.

The FY 2012 Actuarial Review projects that seller funded downpayment assistance loans will cost the FHA MMI Fund over $15 billion. According to HUD's Annual Report to Congress on the Fund, these loans have a "disproportionate share" of FHA loans that are seriously delinquent. SFDPA loans represent 4 percent of FHA's outstanding mortgages but are 13 percent of all seriously delinquent loans.

The independent actuary estimates that without SFDPA loans, the MMI Fund would be a positive $1.77 billion.

IV. FHA has moved swiftly to enforce FHA rules and to hold poor performing lenders accountable for their unsatisfactory performance.

Starting in August 2009 with the termination of Taylor, Bean & Whitaker (TBW), FHA took several high profile enforcement actions that have reverberated throughout the industry. To demonstrate the impact of these actions, mortgage lenders increased credit overlays (underwriting restrictions) on top of FHA requirements.

FHA has also strengthened lender approval requirements by increasing minimum net worth requirements to $ 1 million (that will increase to $2.5 million in 2013). With this change, mortgage lenders have more "skin in the game" in the FHA program. FHA also has increased accountability of approved lenders for the actions of mortgage brokers.

FHA has also raised premiums numerous times in an effort to bolster the Fund.

V. The fundamental problem with the mortgage market today is not that FHA is making too many purchase loans, but that the total purchase mortgage market is not making enough loans.

Much has been written about FHA's dominant role in the mortgage market. A closer look at the data shows, however, that FHA purchase activity is now lower than it was in 2000. Below is a chart with FHA purchase activity from 2000 – 2012. (Source: HUD Annual Report to Congress)

FHA Purchase Activity
(FY 2000-FY 2012)

Year	Mortgages
2000	839,869
2001	806,818
2002	862,898
2003	658,640
2004	586,110
2005	353,844
2006	313,998
2007	278,394
2008	631,655
2009	995,551
2010	1,109,581
2011	777,427
2012	733,864

At the same time, Home Mortgage Disclosure Act data shows that home purchase activity still is falling and is now almost one-half of 2000 levels.

U.S. Total Home Purchase Activity

2000	4,787,356
2001	4,938,809
2002	5,124,767
2003	5,596,292
2004	6,429,988
2005	7,382,012
2006	6,740,322
2007	4,663,267
2008	3,119,692
2009	2,792,939
2010	2,546,590
2011	2,416,854

*Federal Reserve Bulletin - December 2012 "The Mortgage Market in 2011: Highlights from the Data Reported under the Home Mortgage Disclosure Act"

Despite the government's dominant role in the mortgage market, the Federal Housing Administration, Fannie Mae and Freddie Mac only backed about 1.7 million purchase loans last year, which is comparable to 2011 and about 14 percent below 2010.

The private sector has returned to the housing market, just not the mortgage market.

Of course, the major contributor to the housing rebound has been the explosive growth in "all cash" sales. Instead of obtaining mortgages, many wealthy homebuyers/investors have the option of simply paying cash to take advantage of the lower home prices. In the latest National Association of Realtors (NAR) report on existing home sales, cash sales are hovering near 30 percent (historically they were about 5 - 10 percent) of all transactions. For 2012, this translates into about 1.5 million cash sales.

At the opposite end of the housing market are younger, lower income and minority homebuyers who rely on mortgage financing to purchase homes. You only need to look at the latest Harvard Joint Center of Housing Studies report (The State of the Nation's Housing 2012) and Home Mortgage Disclosure Act (HMDA) data to see the impact of the weak mortgage origination numbers on these groups. According to the Harvard study, first-time homebuyers' share of the market has declined from 39 percent to 33 percent and all age groups under the age of 55 saw sharp declines in home purchase activity.

The Federal Reserve's annual HMDA article ("The Mortgage Market in 2011") demonstrates the adverse impact of the current mortgage market on lower income and minority homebuyers. While all homebuyer groups saw a decline in purchase mortgage activity, lower income and African American homebuyers were particularly hard hit with declines that were double other segments.

Examining FHA's Proper Role in the Mortgage Insurance Market

FHA has been criticized for straying from its mission because of the increasing percentage of high credit borrowers in the FHA program. What the critics do not appreciate is that mortgage lenders on their own have tightened guidelines on FHA lending

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

The good news in the FHA (and Fannie Mae and Freddie Mac) performance numbers is that the borrowers being approved today have the highest credit quality as their remarkably low early-default rates demonstrate. Consequently, our current mortgage dilemma does not stem from the approval of homebuyers with poor credit characteristics, but rather, from the inability of many creditworthy borrowers to obtain mortgages.

FHA's role & the private mortgage insurers

It should pointed out at the outset that the private mortgage insurers benefited from FHA's participation in the mortgage market in 2008 -2009. Without FHA to backstop home prices, private mortgage insurer losses would have been even higher during those years.

Some have also criticized FHA for having higher default rates than the private insurers. While the credit characteristics have improved dramatically, the credit profile of privately insured loans is even better.

I believe that the private mortgage insurers should play a vital role in our Nation's housing finance system and it should be expanded. However, their impediment is not the policies of the Federal Housing Administration but rather, the pricing policies of the Government Sponsored Enterprises (GSEs).

As noted above, FHA has already taken significant steps to facilitate the recovery of the private sector by raising its insurance premiums five times in recent years. The FHA premium is now the highest in its history and more than 60 percent higher than it was in May 2008. If FHA raised premiums further, it would place another hurdle in the way of future homebuyers at a time when the housing market needs every homebuyer it can find.

The private mortgage insurers' lack of volume is tied directly to the pricing policies of the Federal Housing Finance Agency and the GSEs. Starting in March 2008, the GSEs added an "adverse market fee" and "loan-level price adjustments" that raised homebuyers' costs for almost all mortgage transactions

The principal reason for the difference in costs associated with an FHA loan and a private MI loan is not the cost of mortgage insurance. FHA and private mortgage insurance premiums are roughly comparable depending on the LTV and credit score. The pricing disparity is the result of the additional GSE fees since Ginnie Mae, the primary secondary market outlet for government loans, only charges a guaranty fee (which the GSEs also charge).

While some would argue that these fees have enabled the GSEs to become profitable, there has been a cost for both homebuyers and the private insurers.

Conclusion

Just as FHA did in the "oil patch" states in the 1980's, FHA has played an invaluable role in supporting the housing market in the aftermath of the housing crisis. It has provided liquidity to the mortgage market when the private sector retreated.

The performance of FHA loans insured since the private mortgage market shows that FHA officials have acted responsibly in balancing FHA's dual mission of serving those not able to find financing from other sources and avoiding risk for the American taxpayer.

Based on the available data, I question whether further changes are necessary to resolve problems that have already been addressed (e.g. seller funded downpayment assistance loans). HUD officials are rightly concerned about "over-correcting" and penalizing future homebuyers.

As the above data also shows, there is still more work to be done to ensure that all creditworthy Americans are able to buy a home. Placing more restrictions on FHA at this time will only make it more difficult for many families to qualify for a mortgage. Equally important, they could increase financial risk for the FHA program and the American taxpayer.

In conclusion, FHA's fundamental challenge has always been to balance the risk associated with serving those not adequately served by the private sector with prudent credit management. I believe the recent performance data demonstrate that FHA is managing this "balance" in a very effective manner.

Appendix

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Analysis of FHA Streamline Refinance Performance

As the debate "heats up" about the Federal Housing Administration's (FHA) financial condition, it is important to evaluate the impact of various products on FHA loan performance. While the excellent credit quality and performance of FHA loans originated since 2009 is well-documented, FHA streamline refinance (S/R) mortgages have performed much worse than the rest of FHA's originations according to FHA's Neighborhood Watch database. The highlights are:

- **Streamline refinances had early default and claim rates up to three times higher than the rest of FHA's recent originations.**

  FHA streamline refinance loans had an early default and claim rate that was up to three times higher than the rate for the rest of FHA's originations. Despite being only 13-18 percent of FHA's originations during this period, streamline refinances were up to 40 percent of FHA's early defaults and claims.

- **While streamline refinance transactions reduce risk for the FHA Fund, they can distort analysis of individual books of business.**

  Streamline refinance transactions reduce risk for the FHA Fund by lowering the interest rate on an existing FHA loan. However, FHA streamline refinance loans also have the effect of making older books look better than they are and making newer books (i.e. those that include streamline refinances of older loans) look worse than would be expected of newly originated loans (based on the improved credit quality of these recent loans).

  For example, assume a homebuyer with a 620 credit score purchased a home in 2007 with an FHA insured mortgage. (In 2007, over 40% of FHA loans had credit scores below 620.) If that borrower refinanced his/her loan in 2009 or 2010 and the streamline refinance became seriously delinquent within two years of origination (i.e. Neighborhood Watch criteria), the appearance would be that the original loan performed and the refinance originated in 2009 or 2010 was indicative of performance issues with those books of business. Credit characteristics of loans made in 2009 and 2010 had much better credit quality than earlier originations. (Contrary to 2007, less than 10% of FHA's loans in those two years had credit scores below 620).

To sum up, the following data substantiates the view that FHA's newer books have record low levels of early default and claim. However, these books are performing even better when the streamline refinance loans (with their higher risk characteristics from the older loans) are excluded from the analysis.

Impact of Streamline Refinance (S/R) Performance of FHA's Recent Originations

Below are several charts that provide data on the performance of streamline refinances and their effect on FHA's total performance. The first chart shows Neighborhood Watch performance data for streamline refinances insured in two-year periods starting with an end date of 2009Q3 (i.e. streamline refinance volume, total S/R early defaults and claims (D/C) and the percentage of streamline refinances that are seriously delinquent). In addition, to provide perspective, the seriously delinquent (S/D) rate for non-streamline loans is provided in bold.

Neighborhood Watch
FHA Streamline Refinances (S/R) Performance for Two-Year Periods By Quarter End Date

Quarter	Early D/C #	Total S/R Originations	S/R % Seriously Delinquent	**Non S/R S/D %**
2009 Q3	16,625	393,746	4.2%	**5.1%**
2009 Q4	24,059	475,307	5.1%	**5.1%**
2010 Q1	26,251	509,418	5.2%	**4.3%**
2010 Q2	27,489	504,984	5.4%	**3.4%**
2010 Q3	33,901	539,175	6.3%	**2.7%**
2010 Q4	38,742	617,401	6.3%	**2.1%**
2011 Q1	30,764	570,695	5.4%	**1.6%**
2011 Q2	19,877	452,358	4.4%	**1.5%**
2011 Q3	15,572	383,987	4.1%	**1.5%**
2011 Q4	10,069	326,978	3.1%	**1.7%**
2012 Q1	8,135	341,278	2.4%	**1.5%**
2012 Q2	8,855	391,401	2.3%	**1.4%**

Starting in 2010, streamline refinance loans have performed much worse than non-streamline refinance transactions (i.e. the rest of FHA's originations during those periods). The S/R early default and claim rate peaked at 6.3% for the two-year periods ending in the last two quarters of 2010. As FHA's over-all credit quality has improved, the S/R early default rate has fallen steadily since 2010.

The last column (bold) of the chart shows that the early default performance of FHA's non-streamline refinance loans improved steadily since 2009. The data shows that FHA's total originations for the two-year period ending in December 2009 were performing comparably to streamline refinances. However, while streamline refinances deteriorated throughout 2010, the performance of FHA's non-streamline business improved steadily and now has the lowest levels of early default in the 13-year history of the Neighborhood Watch database.

Streamline Refinance Mortgages Comprise a Significant Percentage of FHA's Early Defaults and Claims.

Below is a chart that analyzes the share of streamline refinances as a percentage of FHA's total early payment default and claims and total origination volume.

Neighborhood Watch
Streamline Refinances Early Defaults as a Percentage of FHA Early Defaults and Total Volume

Quarter	Total Early D/C #	S/R Early D/ C #	S/R as % of Total Defaults	S/R as % of Total Originations
2009 Q3	142,129	16,625	12%	14%
2009 Q4	162,149	24,059	15%	15%
2010 Q1	151,810	26,251	17%	15%
2010 Q2	126,140	27,489	22%	15%
2010 Q3	110,951	33,901	31%	16%
2010 Q4	96,953	38,742	40%	18%
2011 Q1	74,920	30,764	39%	17%
2011 Q2	58,284	19,877	34%	15%
2011 Q3	52,809	15,572	29%	14%
2011 Q4	47,180	10,069	21%	13%
2012 Q1	40,253	8,135	20%	14%
2012 Q2	36,084	8,855	24%	16%

As can be seen in the chart above, starting in 2010, streamline refinances began comprising a much higher percentage of FHA's early defaults and claims than of FHA's total originations. Streamline refinance transactions peaked at 40% of FHA's early defaults in 2010 4th Quarter. Streamline refinance loans comprised from 13% to 18% of FHA's total volume.

Assessment

This data shows that the poor performance of FHA's older books of business has crept into its newer books through the streamline refinance program. While the FHA program benefits when loans are "streamlined", these loans can distort the analysis of the performance of the newer books since the credit characteristics of the original loan likely have higher risk characteristics than other new originations, which make up over 80 percent of FHA's recent books.

The good news is that FHA's recent books of business, even with streamlines, are performing at record low levels of default. Excluding streamlines, FHA recent books would be performing even better. Accordingly, any analysis of recent books of business should consider the differences in the credit characteristics of streamline refinances loans and the rest of FHA's originations, which are over 80% of FHA's recent originations.

Myths and Facts about FHA

(November 2012)

FHA's single family mortgage insurance program was created in 1934 to provide access to safe, affordable mortgage financing for American families. FHA does not lend money to homeowners. Instead, FHA insures qualified loans made by private lending institutions. Since 1934 FHA has made the dream of homeownership a reality for millions of American families.

During the economic recession and housing downturn, FHA has been one of the only sources of mortgage finance available, and they have weathered the storm well. While banks, lending institutions and private mortgage insurers went bankrupt or collapsed, FHA has been there. During the worst economic crisis of our time, FHA provided access to homeownership to more than 2.8 million first time homebuyers in the last four years.

Today, FHA continues to provide insurance and pay claims. For the first time in its history the program does not currently have a full 30 years' worth of expected claim payments. But as our economy continues to improve, and housing prices continue to rise, so will FHA's financial health. FHA has been the shining light in our economic crisis, and we believe they will continue to be an integral force in our recovery.

MYTH: FHA IS BANKRUPT

FACT: FHA is not bankrupt. FHA's current cash reserves total $30.4 billion. FHA is said to be undercapitalized because their independent actuary estimates that they do not currently have sufficient reserves to pay projected claims over the next 30 years. FHA is one of the few entities required by law to hold reserves for claims over a 30 year period. By comparison, the Financial Accounting Standards Board only requires private financial institutions to hold reserves for losses over the next 12 months.

What many commentators do not mention is the fact that the FY12 Actuarial Review shows FHA will be fully capitalized again in FY2014, and will reach the desired 2% capital reserves ratio by 2017, which is above and beyond the required 30-years' worth of reserves. FHA also reports that "it is possible to return the MMI Fund capital ratio to a positive level within the year."

MYTH: FHA IS EXPERIENCING HIGH DEFAULTS AND FORECLOSURES

FACT: FHA, like every other holder of mortgage risk, has incurred financial losses as a result of overall market conditions that have led to increased foreclosures. An analysis of FHA data indicates FHA's problem is concentrated in older FHA loans that were significantly affected by the 33% decline in house prices since 2006. There has been widespread improvement in the performance of FHA loans since the market collapsed in 2008. But the legacy loans from 2007-2009 are placing a high burden on the fund. Seventy (70) billion dollars in projected future claims are attributable to that book of business.

It must be noted that the more recent book is performing very strongly; loans insured since 2010 are of high quality and are expected to continue to perform very well. Early payment defaults peaked in 2008 at 2.6% and are now at 0.3%. According to the most recent delinquency survey conducted by the Mortgage Bankers Association, "the total past due rate for FHA loans is now at its lowest level in over 10 years, and FHA's post-2010 books are performing much better than loans originated prior to 2010."

MYTH: FHA's MARKET SHARE IS TOO HIGH
FACT: FHA's market share is too high when viewed in the historical context. But it is performing the very role it was designed to do – filling the credit gap when private lenders flee the mortgage market. From FY1994 to FY 2002, FHA averaged about a 13% market share for loan originations. By FY 2006, FHA's share had declined to a low of 3.77%. FHA's market share peaked at 19.3% in 2010, is now returning to traditional levels and stands at 15.78% in FY2012. As housing markets stabilize and new mortgage regulations are finalized, private markets will once again have some certainty and the private market will return. This will allow FHA's market share to decline even further.

MYTH: FHA IS SQUEEZING OUT THE PRIVATE MARKET
FACT: FHA does not lend money. FHA insures loans made by the private market. FHA has been critical in filling the gap when the private market abandoned housing finance. Today, FHA does not insure loans over $729,750. If FHA was squeezing out the private market, we would expect that private lenders would be active in the market for mortgages over $729,750. Yet there is a significant lack of private credit in that market. Furthermore, FHA and the GSEs have greatly restricted their participation in the mortgage market for condominiums. Yet the private market hasn't thrived in this space either. With the private market unable or unwilling to return to housing markets, the role of FHA has never been more critical.

MYTH: FHA IS NOT SERVING ITS MISSION
FACT: FHA was created in 1934 during a similarly difficult time in housing finance markets when there was little private lending. Today, the agency is filling just the role it was designed for – to provide safe, affordable financing when the private market cannot or will not participate. In FY2011, over half of all African Americans who purchased a home and forty-nine percent of Hispanics did so with FHA financing. Moreover, 78% of FHA's borrowers were first time homebuyers.

MYTH: FHA BORROWERS ARE POOR RISKS
FACT: FHA borrowers today have credit scores at historically high levels. The average credit score for FHA purchase loans was 700 in FY12, compared to 696 in FY11. More than 30% of FHA borrowers in FY12 had credit scores above 720.

MYTH: FHA BORROWERS ARE HIGHLY SUBSIDIZED
FACT: FHA borrowers pay significant premiums to cover their mortgage insurance. Over the last 2 years, FHA has increased their premiums four times. In fact, today FHA's premiums – both the upfront and the annual – are higher than they have ever been. Today's premiums include a 1.75% upfront premium, and 1.25% in an annual premium, that is paid monthly. Furthermore, the FHA has also announced moving forward that they will increase the annual fee to 1.35%.