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Hearing before the U.S. House of Representatives
Committee on Financial Services
on
"Perspectives on the Health of the FHA Single-family Insurance Fund

Thursday, December 1, 2011

Chairman Bachus, Ranking Member Frank, and Members of the Committee, thank you for the opportunity to provide this statement on the health of the FHA Single-family Insurance Fund.

We are now more than four years removed from the collapse of the housing market and the Federal Housing Administration remains actuarially sound according to its FY 2011 Actuarial Review and is now expected to return to a capital ratio above 2 percent in 2014.

The primary reason for the independent actuary's conclusion is the outstanding performance of the FHA loans insured since 2009. In fact, loans insured since 2009 generate over $18 billion of economic value for the fund. Accordingly, instead of becoming the "subprime dumping ground" like some critics predicted after the subprime market collapsed, FHA has been able to weather the worst economic conditions since the Great Depression because of the exceptional quality of its recent books of business.

FHA's cash reserves also increased in FY 2011 to over $33 billion. Even FHA's critics admit that FHA is in no danger of needing additional funding of any type for a couple of years (in a worst case scenario).

I am not suggesting that FHA is "out of woods". No one can dispute the existence of economic risk for FHA today. FHA, like any other holder of mortgage risk, will be affected by continuing house price instability and an unemployment rate hovering around 9 percent. Those concerns are also reflected in the actuarial analysis and are the fundamental reasons why FHA's reserves have fallen in the FY 2011 review.

However, to fulfill its public purpose and counter-cyclical role in the housing market. FHA cannot avoid this economic risk. FHA's challenge is to balance this risk with prudent credit management. I believe the recent performance data demonstrate that FHA is managing this "balance" in a very effective manner.

To summarize, if FHA had not stepped-in and "backstopped" the housing market (particularly home purchases) these past few years, I believe that FHA would be in far worse financial shape today and the Committee would be meeting under even more troubling circumstances for both FHA and the broader housing market.

In this statement, I will first review FHA performance data and then discuss FHA's role in the mortgage market going forward including its relationship with the private mortgage insurance industry.

FHA Loan Performance

FHA's 2009-2011 books comprise over 70% of FHA's portfolio) and are performing at historic low levels of default despite the economic upheaval of the last five years.

To evaluate FHA performance, there are two public early period delinquency measures. They are: 1) Early period delinquency rates provided in the Quarterly Reports to Congress and 2) FHA's Neighborhood Watch system.

- **Early–period delinquency rates**
  (Link to FHA Quarterly Report to Congress – September 30, 2011 http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/rmra/oe/rpts/rtc/fhartcqtrly p.20)
    - Below is a chart comparing FHA's early period delinquency rates (serious delinquency "within first six required mortgage payments") for 2007-2010 (3Q). (Partial fourth quarter data for 2010 are included to demonstrate the continued improvement.)

Early Period Delinquency Rate
All FHA Loans

Origination Quarter	Early Period Delinquency Rate
▪ 2007 (July-Sep)	2.40%
▪ 2008 (July-Sep)	1.78%
▪ 2009 (July-Sep)	.68%
▪ 2010 (July-Sep)	.39%
▪ 2010 (Oct – Nov)	.30%

The early period delinquency rate has fallen 88% from 2007 to 2010 and has averaged below .4% for originations in the first 11 months of 2010.

- **FHA's Neighborhood Watch System**
  Neighborhood Watch is a public database that was implemented in 1999 and tracks loan performance for loans originated in the most recent two-year periods.

(Link to Neighborhood Watch - https://entp.hud.gov/sfnw/public/)

- The seriously delinquent rate for loans originated in the last two years (October 2009 – September 2011) declined to 1.88%. The seriously delinquent rate had peaked at 5.05% in December 2009 (for loans originated from October 2009 to September 2011). (See Neighborhood Watch quarterly report in Appendix)

- Equally important, the number of seriously delinquent recent originations has also declined significantly. Of the loans originated in the two-year period ending in September 2011, 52,809 mortgages were seriously delinquent, compared to 162,149 loans for the two-year period ending December 2009, a 67 percent decline.

- Only 9 percent of FHA's seriously delinquent loans in its portfolio were originated in the last two years (through September 30, 2011). In December 2009, 30 percent of the seriously delinquent loans in the FHA portfolio were originated in the previous two years.

- To provide some historical context, FHA's seriously delinquent rate for loans originated in the two-year period ending September 30, 2011 is also more than 25 percent lower than the rate for the two-year period ending in June 1999. At that time, the seriously delinquent rate was 2,55 percent.

What are the reasons for FHA's excellent performance?

- **FHA credit quality has improved markedly since 2007.**
  (FHA's Quarterly Report to Congress dated September 30, 2011 – page 7).

  - More borrowers with higher credit scores
    - 35% of FHA borrowers in 2010 and 2011 (first half) had credit scores over 720; 10% of FHA borrowers had credit scores over 720 in 2007.
    - 59% of FHA borrowers in 2010 and 2011 (first half) had credit scores over 680; 19% of FHA borrowers had credit scores over 680 in 2007.

  - Fewer borrowers with lower credit scores
    - 3% of FHA borrowers in 2010 and 2011 (first half) had credit scores under 620; nearly 50% of FHA borrowers had credit scores below 620 in 2007.

FHA credit quality has improved steadily since 2007, 4th quarter. Over 50% of FHA loans made in every quarter since 2009 (2nd quarter) had credit scores above 680. In 2006 and 2007, only about 20% of the FHA loans insured in 2006-2007 had credit scores above 680.

Importance of credit score on FHA loan performance

FHA loans with credit scores above 680 and low downpayments (loan-to-value ratios (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 before this Committee 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 chart below.)

FHA Single Family Insured Loan Claim Rates
Relative Experience by Loan-to-Value and Credit Score Values
Ratios of each Combination's Claim Rate to that of the Lowest Risk Cell

Loan-to-Value Ratio Ranges	Credit Score Ranges			
	500-579	580-619	620-679	680-8!
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**

This chart documents the fact that FHA loans with credit scores over 680 and loan-to-value ratios over 95% perform better than FHA loans with credit scores between 620-679 and LTVs of 90% or less.

- **Seller funded downpayment assistance loans eliminated in FY 2008 were a major cause of FHA's financial issues.**
  - The FY 2011 audit also estimated that SFDPA loans "contribute *negative* $14.12 billion to the economic value of the Fund".
    - FY 2011 economic value would have been over $15 billion and the capital ratio would be almost 2% without seller funded downpayment assistance loans.
  - SFDPA loans outstanding at the end of FY 2011 are now less than 6% of the current portfolio),

- **FHA loan-to-value ratios have declined significantly in recent years.**
    - FHA maximum loan-to-value calculations frequently exceeded 100 percent (often 102-103 percent) in the 1980's and 1990's.
        - Starting in 1983, FHA charged an upfront insurance premium of 3.8 percent that could be financed and closing costs (which depending on the State could exceed 3 percent) could be included in the calculation of the maximum loan amount.
        - Currently the maximum LTV is 96.5 percent and closing costs cannot be financed. The upfront premium is only 1 percent making the maximum LTV only 97.5 percent (with the premium).

- **Lender credit overlays have reduced risk for the Fund**

FHA has been recently 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.

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

Starting in early 2008, FHA's credit quality began to improve steadily. In actual number of loans, the change is equally significant. In 2007, FHA insured about 150,000 loans with credit scores below 620. In 2010, FHA insured less than 50,000 loans with credit scores below 620 even though FHA activity was approximately four or five times FY 2007 levels.

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

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

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

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

Reputational risk is also on public display in FHA's Neighborhood Watch database that tracks early default and claim loan performance. In addition to targeting FHA audits and sanctioning lenders with high default rates, this database lets business partners, Congress, the press and public examine individual lender performance in any state, city or ZIP code in the country.

Taken together, the "backloading" of loan compensation, reputational risk and transparency strongly influence lender behavior. Put another way, it is in the industry's self-interest to originate well-underwritten FHA loans.

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

FHA's role in the mortgage market going forward

The good news in the FHA 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 housing 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.

It is no wonder that Federal Reserve Board Chairman Bernanke has been almost pleading for policymakers to take "useful" steps to spur housing and help revitalize the broader economy. The phrase "housing market remained depressed" has been a staple of the Federal Open Market Committee minutes for the last 18 months.

There are too many promising homebuyers being excluded from the housing market. Chairman Bernanke underscored the seriousness of this problem when he said the following in response to a question at his June 2011 press conference:

"... the bottom third of people who might have qualified for a prime mortgage in terms of, say, FICO scores a few years ago cannot qualify today."

This lack of financing is stifling demand and contributing to the weight on home prices and the broader economic recovery. The FOMC minutes from earlier this year detail the problem: "declining house prices remained a drag on household wealth and thus on consumer spending."

As a consequence, the primary threat today to the government housing programs and ultimately the American taxpayer emanate from weak home prices. The current dilemma is epitomized by the concern about the FHA audit. Despite FHA's excellent credit quality and loan performance, the audit (and therefore questions about FHA's solvency) depends heavily on projections about the future house prices.

Rather than looking for ways to lessen the government's role, the immediate focus needs to be on revitalizing a sputtering housing market, dealing with the shadow inventory and avoiding further declines in house prices. The current market should not be held hostage by the poor performance of risky products and poor underwriting of the "bubble" years. They already have done enough damage to millions of American families.

FHA's role & the private mortgage insurers

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).

FHA has already taken significant steps to facilitate the recovery of the private sector by raising its insurance premiums four times in the last three years. The FHA premium is now in its history and about 60% 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 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. For purchase loans with a 95% a loan-to-value ratio, these price increases ranged from 75 basis points to 300 basis points depending on the borrower credit score. On a $200,000 mortgage, this adds $1,500 to $6,000 to the borrower's closing costs.

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).

Conclusion

With FHA's book of business growing from $300 billion to over $1 trillion during one of the most challenging economic periods in our country's history, it is a good thing that policy analysts both inside and outside of government are examining FHA's performance and financial stability. However, t is important to remember that these analyses are often based on projections about what might happen rather than what is actually occurring. On the other hand, no one can dispute that FHA loan performance on recent books of business has improved dramatically and is now at historic low levels of default.

Appendix – Neighborhood Watch

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

Rank	Area	Quarter End Date	Total Orig.	Total Seriously Delinquent	Total Claims	Total Seriously Delinquent and Claims	% Seriously Delinquent and Claims
1	United States	09/30/2011	2,814,002	49,827	2,982	52,809	1.88
2	United States	06/30/2011	3,060,771	54,698	3,586	58,284	1.90
3	United States	03/31/2011	3,311,056	70,206	4,714	74,920	2.26
4	United States	12/31/2010	3,430,615	90,936	6,017	96,953	2.83
5	United States	09/30/2010	3,442,543	103,198	7,753	110,951	3.22
6	United States	06/30/2010	3,446,807	117,934	8,206	126,140	3.66
7	United States	03/31/2010	3,399,995	142,832	8,978	151,810	4.47
8	United States	12/31/2009	3,212,363	154,190	7,959	162,149	5.05
9	United States	09/30/2009	2,878,599	134,910	7,219	142,129	4.94
10	United States	06/30/2009	2,483,073	105,969	6,144	112,113	4.52
11	United States	03/31/2009	2,105,924	88,002	5,244	93,246	4.43
12	United States	12/31/2008	1,788,355	72,809	4,210	77,019	4.31
13	United States	09/30/2008	1,477,687	50,088	3,508	53,596	3.63