

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

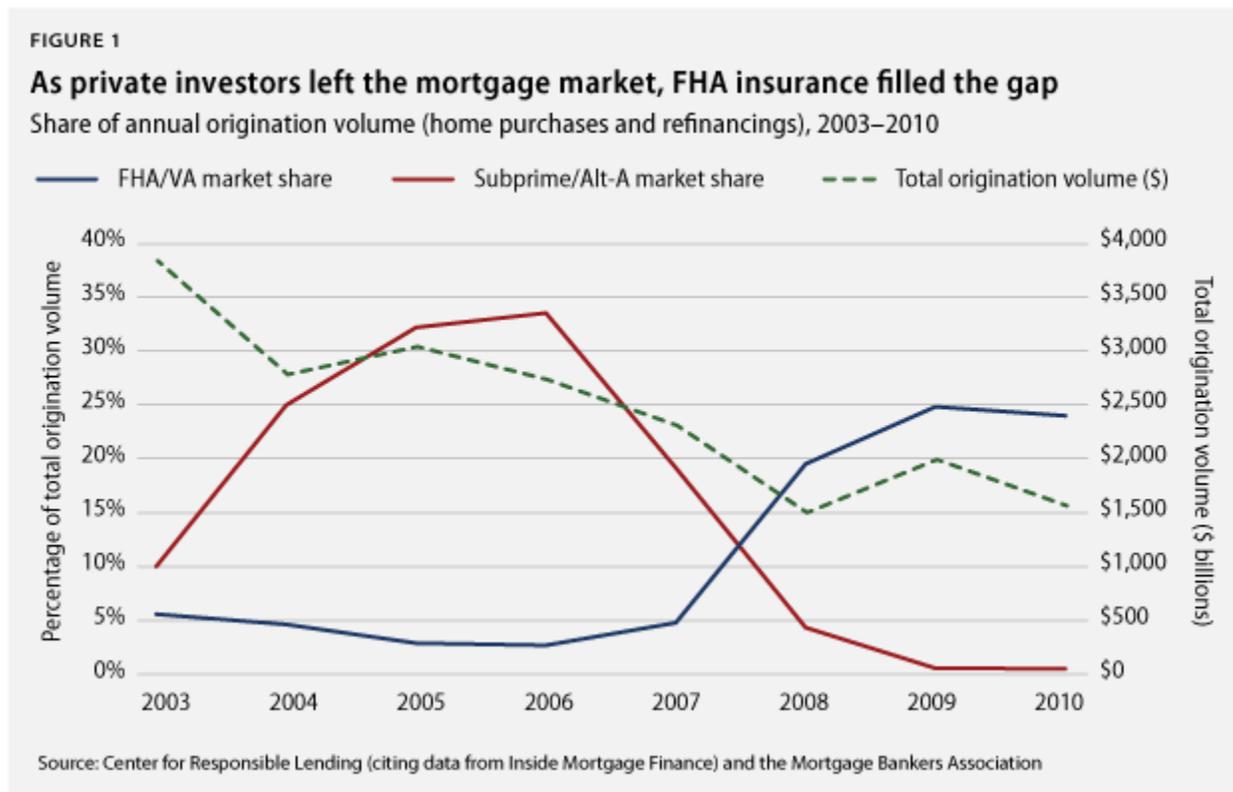
Yet, these loans required less paperwork and tended to offer far better compensation for their originators than FHA-backed loans, in part due to creditor bonuses to brokers for steering borrowers into riskier and more expensive loans than they qualified for.³ As a result, many borrowers who would have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



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 endorsements¹² were for home purchase loans whereas only 28 percent of Fannie Mae and Freddie Mac originations were for home purchase loans.¹³

B. Without the Federal Housing Administration, the Housing Downturn Would Have Been Much Worse.

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 announced²³ 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.

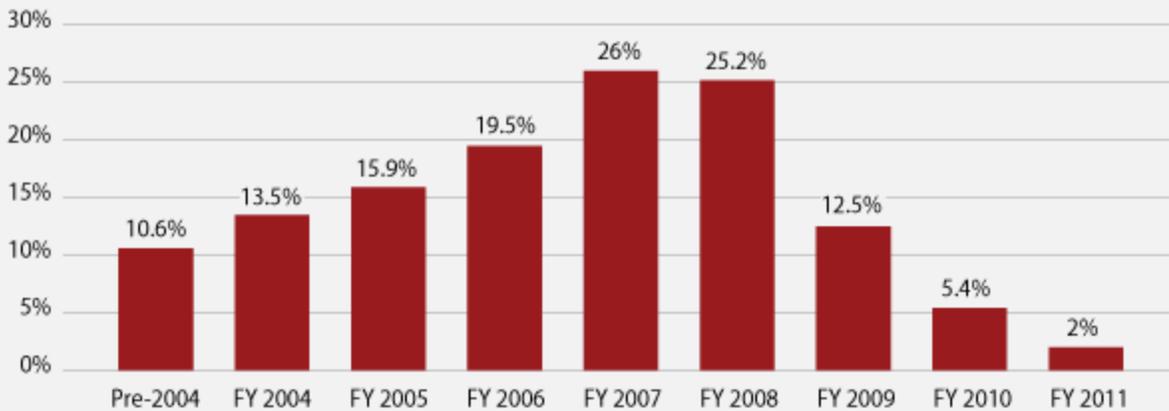
To understand whether the current condition of the agency's mortgage insurance fund is due to the recent crisis or to a fundamental problem with its model, consider where the current losses are coming from. The agency is currently facing massive losses on loans insured in the later years of the housing 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

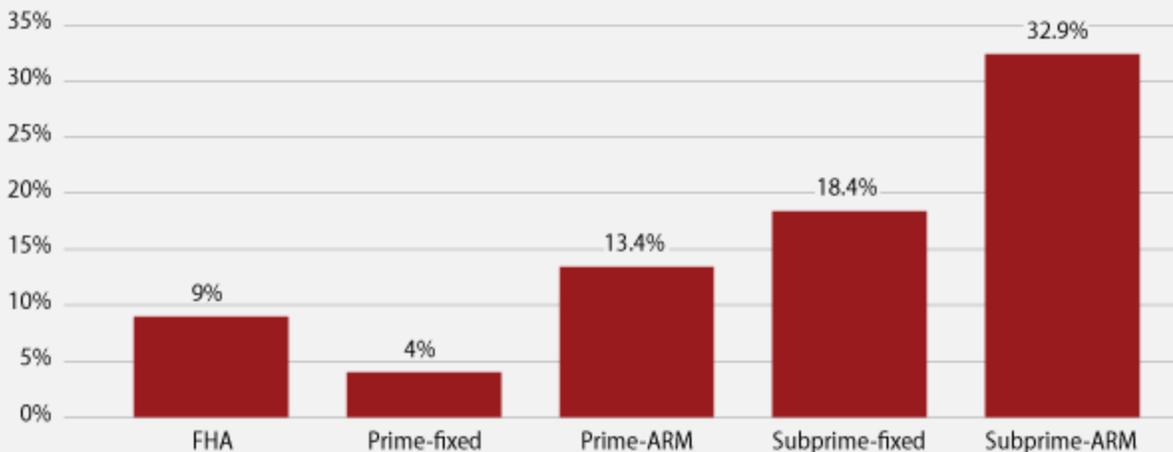
Percentage of FHA-backed mortgages that have missed at least three consecutive payments or are in bankruptcy/foreclosure processing



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 bankruptcy/foreclosure processing by type of loan



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

One of the reasons for the outside 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.

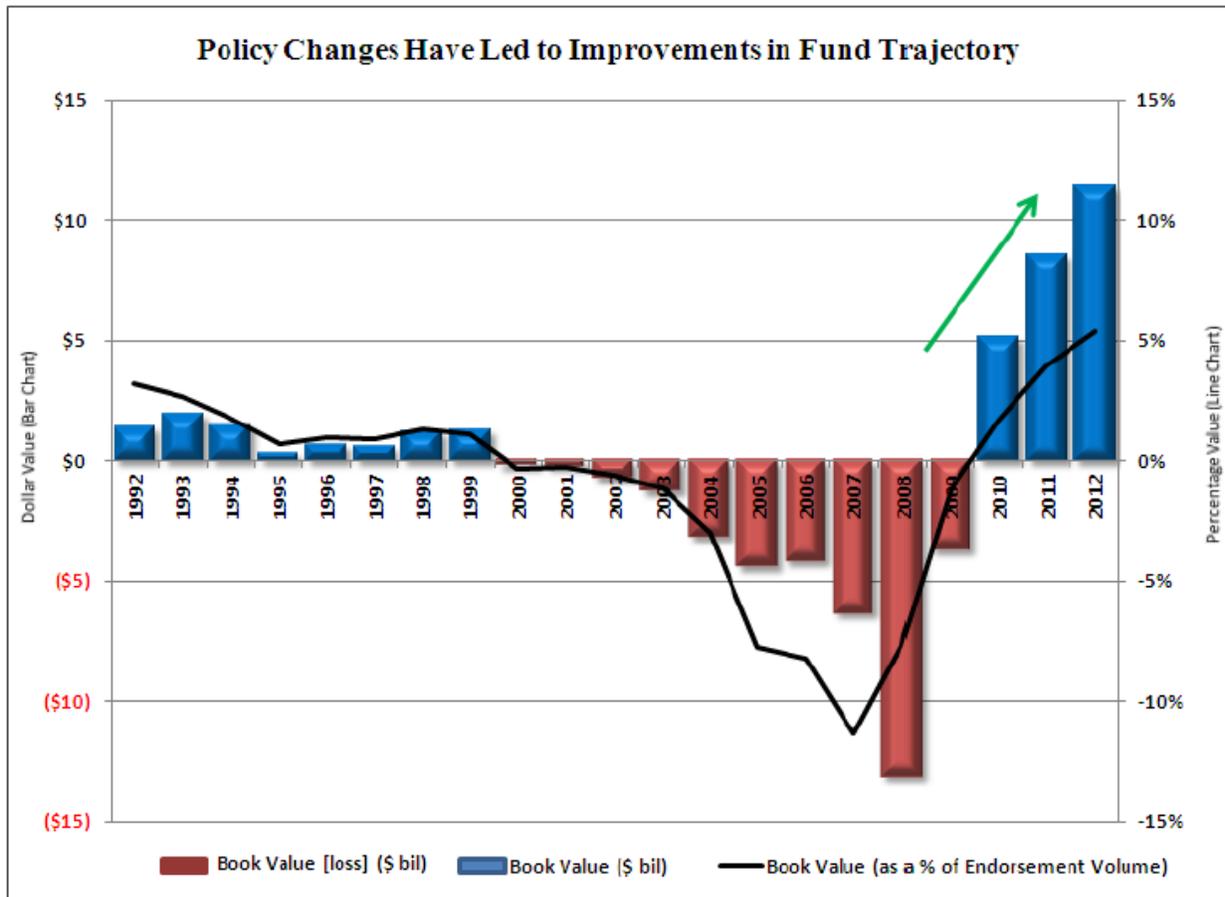
Some of the improvement going forward will result from the dramatic decline in loan delinquencies and defaults. The single-family portfolio's ninety-day delinquency rate, often the first indication of strength or weakness of new insurance commitments, was approximately 0.3 percent in early 2012³¹. As 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.

ENDNOTES

- ¹ Unpublished data estimates from Moody's Analytics, October 2010. Data provided to Center for American Progress from Moody's Analytics.
- ² Julia Gordon, Testimony before the Financial Crisis Inquiry Commission, January 13, 2010, available at <http://www.responsiblelending.org/mortgage-lending/policy-legislation/Gordon-FIC-testimony-final.pdf>.
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- ¹⁵ Unpublished data estimates from Moody's Analytics, October 2010.
- ¹⁶ Mark Zandi, "Obama policies ended housing free fall," *The Washington Post*, September 28, 2012, available at http://articles.washingtonpost.com/2012-09-28/news/35495982_1_house-prices-home-buyers-tax-credits.
- ¹⁷ U.S. Department of Housing and Urban Development, "Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2012."
- ¹⁸ *Omnibus Budget Reconciliation Act of 1990*, Public Law 101-508, 101st Congress, (November 5, 1990). Note that FHA need not regenerate its capital reserves in one fell swoop. By law, the HUD secretary is required only to come up with a viable recapitalization plan. When Congress instituted the capital ratio requirement in 1990, it gave HUD ten years to increase its capital from zero to 2 percent. It took only three years for FHA to reach the threshold, thanks in part to increased insurance premiums.
- ¹⁹ Robert Quercia and Kevin Park, "Sustaining and Expanding the Market: The Public Purpose of the Federal Housing Administration," (Chapel Hill, NC: UNC Center for Community Capital, 2012), available at http://ccc.unc.edu/documents/Dec2012_FHASustainingAndExpandingMarket.pdf.
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³⁰ *Ibid*.

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