



Written Testimony

of

**Sarah Rosen Wartell**

**President, Urban Institute**

for the hearing entitled

**“Sustainable Housing Finance: Perspectives on Reforming FHA”**

before the

**House Financial Services Committee**

**Subcommittee on Housing and Insurance**

Wednesday, April 10, 2013, 10:00 AM

2128 Rayburn House Office Building

Sarah Rosen Wartell is indebted to Ed Golding, Sharon Carney, and Matt Rogers for their assistance in preparing this testimony and to Mark Willis and other participants in a roundtable on the future of FHA for helping to shape some of the concepts described herein. The views expressed, however, are solely her own and should not be attributed to the Urban Institute, its employees, or any other person or organization with which she is affiliated.

## **Introduction**

Chairman Neugebauer, Ranking Member Capuano, and Members of the Committee, I thank you for the opportunity to testify today about reforming the Federal Housing Administration (FHA) to ensure a sustainable housing finance system.

My testimony focuses on steps Congress can take **now** to improve FHA's financial health by strengthening its ability to assess and manage risk and mitigate loss. These proposals are aimed at helping the agency become more nimble, efficient, and capable of acting quickly to protect taxpayers. Some of these measures won broad bipartisan support from this Chamber last year, although I suggest some further refinements and additions to that legislation. I urge you to rapidly enact these achievable measures rather than let more time pass while costs mount to FHA. There is no reason FHA cannot perform better and strengthen its finances more quickly with your help.

At the same time that I urge you to take prompt action to help FHA strengthen its financial position, I suggest you **only** consider the broader issue of FHA's mission and place in the larger housing finance system in the context of housing finance system reform. Policymakers must resolve how to attract sufficient private capital to provide long-term, fixed-rate mortgages after Fannie Mae and Freddie Mac are wound down before we can understand what is left for FHA to do.

The good news is that FHA's market share has fallen and is on downward trajectory. The private market is slowly returning. With recent changes to its premium structure, FHA seems to now be more expensive than private mortgage insurance where available for low-down payment borrowers with better credit scores. Although the credit quality of FHA-insured lending right now is very high, the majority of FHA's loans are on terms that private insurers or the government-sponsored enterprises (GSEs) will not yet accept. In the past, after FHA played a critical countercyclical role, FHA's weakened capital reserves soon recovered and its market share shrank, allowing private capital to play a larger and larger role in the housing market. We seem to be on the same path again—to the good.

There are some policy measures under discussion that would limit access to FHA-insured mortgages artificially, rather than let market forces do their work. Some of these measures would do great harm to FHA's ability to play an indispensable countercyclical role in the future when needed. They also would limit FHA's ability to serve its ever-important mission of ensuring financing is available to creditworthy borrowers who have limited options in the private market.

What is more, it will be—at a minimum—many months until there is legislation that could pass this body and be signed by the President on broader housing finance reform. The shape of the system that results will determine what role FHA must play. The need for FHA's full-loan insurance will be larger if the GSEs are unwound without a new, more limited, fully-paid-for liquidity guarantee. FHA can be assigned a more limited role under normal economic conditions if there is a replacement “conforming” market in which private capital stands in front of a catastrophic government guarantee.

I urge the Congress to tackle quickly what is possible and urgently needed: improvements to FHA's ability to manage risk and reduce losses. You should act to begin to bring down the FHA loan limits gradually, while continuing to recognize the different market conditions that exist in high-cost areas. If you choose to delay these measures while Congress debates broader mission questions for FHA and the system as a whole, the result will be further avoidable losses to the FHA fund. There is no reason not to take measures to protect taxpayers from those avoidable costs. You will have ample opportunity to consider FHA mission reform, as needed, in the context of future legislation. I hope you will consider these measures prerequisites to a broader legislative agenda for housing finance system reform.

## **My Background**

For 20 years, I have worked on housing finance policy issues. I began my career in public policy with a five-year stint as an official at FHA, advising the FHA Commissioner and HUD Secretary on housing finance, mortgage markets, and consumer protection. I held a variety of positions at FHA including deputy assistant secretary for operations and associate general deputy assistant secretary for housing, and I helped develop a 1995 legislative proposal to transform FHA into “a results-oriented, financially accountable [government corporation known as the Federal Housing Corporation that would] utilize the strengths of private market partners to expand homeownership opportunities, ...[while continuing] to serve the needs of working families who require low-downpayment loans, and residents in central cities, older neighborhoods, and other underserved markets, and develop more affordable rental housing.”<sup>1</sup>

After HUD and my subsequent tenure as deputy assistant to the president at the National Economic Council in the White House, I served as a consultant to the bipartisan Millennial Housing Commission, where I wrote about how FHA faced management weaknesses and growing risk with inadequate risk management tools and evaluated the pros and cons of using single-family risk-sharing pilots to help FHA better protect taxpayers and serve its mission.<sup>2</sup> Later, in 2007, at the Center for American Progress, I convened the Mortgage Finance Working Group, a cross-sector coalition of individuals working to understand and develop policy responses to the emerging mortgage market crisis, which proposed one of the first plans to unwind the GSEs, bring private capital back into the system, and ensure public purposes are well served.

Now, at the Urban Institute, I am responsible for leading an organization that provides independent research and analysis on a wide array of issues, from tax policy to community development to health care and more. The Institute is working to launch a new research initiative with the capacity to provide data and analysis to inform policymakers on housing finance questions.

---

<sup>1</sup> “Reinvention,” by Henry Cisneros, June 29, 1995, available at <http://archives.hud.gov/remarks/cisneros/whyhud/reinvent.cfm>.

<sup>2</sup> Sarah Rosen Wartell, “Single-Family Risksharing: An Evaluation of Its Potential as a Tool for FHA,” June 2002, available at <http://govinfo.library.unt.edu/mhc/papers.html>.

## How FHA Got Here

FHA plays a critical countercyclical role in the housing market and the larger economy that requires taking risk. FHA tries to price for that risk accurately to absorb costs under most likely circumstances; but, like most housing market participants, it rarely gets it just right.

Like most insurance, during good times, the excess of premiums collected over the cost of claims builds up in the FHA fund, creating a capital reserve. But, low-down payment mortgages will experience elevated defaults when house prices fall and unemployment rises. Given that we have seen the worst housing downturn since the Great Depression, we should not be surprised to see that defaults increased and the MMI Fund experienced significant outflows.

There were two principal causes of recent losses. First, FHA insurance premiums were insufficient to cover costs of insurance buffeted by rapidly falling home values amidst a foreclosure crisis, falling incomes, and rising unemployment stemming from the deepest recession in many, many decades. In short, many of these losses were inevitable—the result of FHA playing an indispensable countercyclical role, without which losses to the U.S. economy, U.S. homeowners, and U.S. taxpayers through the conservatorship of Fannie Mae and Freddie Mac would have been far greater.

Second, FHA incurred costs that were avoidable. Many of its losses stemmed from specific products that performed badly. Even as their poor design became apparent, FHA had great difficulty shutting down these products. And as bad actors turned to FHA when other capital sources dried up, FHA was slow to identify and shut down ineffective originators and underperforming servicers. In many cases, FHA officials knew of the problems, but they are not able—as their private-sector counterparts are—to act quickly to avoid further losses. Rather, stemming these losses required lengthy rulemaking processes and even legislative requests, some of which have been pending before Congress since 2010.

A few other observations:

- The countercyclical nature of the FHA has helped avoid costs. During most of the worst origination years in the market (2005 through 2008), FHA had relatively low volumes. Thus, although the performance of those books was poor, as it proved to be for most market participants, the absolute size of the losses was less than it would have been if the poor performing books of business had been above average in size.
- The greatest net cost to the FHA Fund was at the pivot point, when private capital was fleeing the market and originators accustomed to generating lower-quality product looked for new outlets. Too much of that weak product ended up in FHA's portfolio before FHA could tighten its own standards. According to HUD reports, the worst years were 2007 and 2008:

The (single-family) books-of-business insured prior to 2010 are expected to generate large losses for the MMI Fund. The peak book for losses per-dollar of insured loans is 2007, the year that also has experienced the greatest total decline

in home values. When that book is finally closed, its total cost is expected to exceed 11.3 percent of the initial dollar volume of loans insured. Though the 2008 book has a lower loss-per-dollar (7.7 percent), that book was three times as large as 2007, and therefore, has expected dollar losses that are more than twice those of 2007 book (\$13.2 billion versus \$6.4 billion).<sup>3</sup>

- As standards tightened across the industry and FHA tightened its own rules, while private lender competition for high-quality credit borrowers disappeared, the credit quality in FHA's book of business grew tremendously. So newer books of business start to have net economic value for FHA, allowing it to begin to rebuild its capital. By 2010, early defaults had dropped dramatically and premium income had grown, leaving actuaries to predict that the economic value of the post-2009 books of business would speed the replenishment of the FHA Fund.
- This phenomenon is typical of many insurance markets: the new books following the collapse are replenishing the fund. This *diversification across time* is an important element of insurance markets where there is high correlation of outcomes within the pool, such as property and casualty insurance. As former FHA Commissioner John Weicher, now of the Hudson Institute, tells the story, this pattern is very similar to that which FHA experienced in 1980 to 1982.<sup>4</sup>
- The increase in loan limits mandated by Congress also appears to have helped FHA to replenish the Fund. At a time when private capital and the GSEs were accepting only pristine credit with high down payments, higher-LTV larger-dollar loans for FHA appear to have strengthened the performance of the Fund.<sup>5</sup> As economic times improve and private capital returns, however, these non-mission-related, high-dollar insured loans should no longer flow into FHA's portfolio where they inflate the total amount of insurance exposure of the taxpayers, regardless of the economic value of those books of business. *It is time for loan limits to come down, albeit gradually.*
- We learn (or relearn) from these periods that certain products and practices disproportionately contribute to loss. In general, reduced documentation, an abundance of second mortgages, and lax appraisals increase losses.
- In the case of FHA, seller-funded down payment assistance (SFDPA) and other seller contributions had much the same effect as second mortgages, which, along with lax

---

<sup>3</sup> 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*, November 16, 2012, at 42–43.

<sup>4</sup> Presentation by John Weicher at the American Enterprise Institute, January 24, 2013, available at [http://www.aei.org/files/2013/01/24/-john-weicher-fha-presentation\\_110740723232.pdf](http://www.aei.org/files/2013/01/24/-john-weicher-fha-presentation_110740723232.pdf).

<sup>5</sup> U.S. Department of Housing and Urban Development, slidedeck on *Annual Report to Congress, Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund*, November 16, 2012, available at <http://portal.hud.gov/hudportal/documents/huddoc?id=111912FHAActRevPolResp.pdf>.

appraisals, increased defaults in the program. For example, cumulative to date claim rates on the 2005 originations are over 20 percent when there was assistance from nonprofits compared to a rate of 9 percent when there was no assistance.<sup>6</sup> The Actuary estimated that SFDPA loans reduced the economic net worth of the MMI Fund by \$15 billion. If FHA had never insured any SFDPA loans, the last actuarial report would have still shown a positive economic value for the Fund.

- The Home Equity Conversion Mortgage (HECM) program—the FHA program that first pioneered the reverse mortgage—has proven to be another major source of loss for FHA. When Ginnie Mae designed a securitization vehicle for HECMs in 2008, the product took off, with many lenders originating loans that allowed borrowers to take large cash amounts out of home value at one time, leaving them with limited resources to pay property taxes and other ongoing expenses. A well-designed HECM converts home equity into an annuity at reasonable rates for living expenses. Performance of HECMs is especially vulnerable to home value fluctuations. FHA has tightened these standards significantly, but its authority to make changes is limited, and the slow pace of the rulemaking process necessary to return the program to its intended purpose has left the door wide open with FHA continuing to incur losses as program changes make their way through the regulatory process. (See recommended additions to the FHA Fiscal Solvency Act below.)

### **Recommended Measures to Reduce Costs and Mitigate Risks**

A key pattern emerges from looking at FHA’s recent performance. When FHA incurred losses that it might have avoided—that is, those losses which were not fundamental to FHA’s countercyclical role or the inevitable consequence of calamitous economic and housing market conditions—the losses stemmed from the slow pace of change at FHA and the ways in which a government agency cannot typically act as quickly as a private company can to protect itself against risk.

Think about the steps taken by the capital market investors to reduce their exposure to mortgages quickly as the market meltdown began. Think about how financial institutions tightened underwriting standards virtually overnight and dropped products that were proving to be expensive as soon as the costs were understood. Officials at a wide range of institutions exposed to mortgage credit risk, even at the GSEs, were able to comparatively quickly take steps to stop the bleeding. But not so at FHA.

HUD has recommended some legislative changes to help it reduce losses in key programs, including authority to seek indemnification from direct endorsement lenders, terminate origination and underwriting approval for inadequate lenders, transfer servicing by mortgagee letter, and revise the compare ratio requirement. Overall, I support the secretary’s requests, and I discuss in the following sections some changes to current bill language to accomplish these goals. But I believe even more needs to be done, and, in some cases, the proposed changes are

---

<sup>6</sup> Ibid.

too timid. I recommend several actions that would better enable FHA to assess risk, act more nimbly to mitigate it, and, ultimately, operate more efficiently and sustainably. These recommendations promise quick impact, they are both politically and operationally feasible, and they are not mired in ideological debate. Rather, these are rational, responsible ways to reduce risk to taxpayers quickly.

- **“Risk management emergency powers: emergency authority to suspend issuing insurance under risky terms and conditions.”** I propose a way to respond to the constraints of government processes, create greater transparency, and ensure opportunity for effective congressional oversight. Congress should give the HUD secretary special emergency powers to suspend FHA insurance programs or make emergency modifications to the program when the secretary finds that continuation under current program terms *exposes the taxpayers to “elevated risk of loss” and “fails to serve the public interest.”* Any such emergency action to terminate insurance would need to be accompanied by analyses of (1) the potential cost savings to the FHA Fund and the taxpayer risk that would be avoided; and (2) whether the program objectives established by Congress would be furthered or harmed by temporarily suspending insurance until program terms and conditions can be altered. The emergency authority proposed here would be time limited, requiring the HUD secretary to complete all appropriate administrative procedures to make the change permanent (or seek congressional authorization if a statutory mandate was involved). Congress could at any time vote to disapprove the use of the emergency powers by the secretary if they felt the risk was not properly assessed or the change was not necessary to meet public ends.

FHA has also faced difficulty in establishing early-warning risk indicators and in taking steps quickly to stop specific originators from continuing to add loans to FHA’s insurance portfolio which are markedly more likely than others to end in default. Commissioner Galante testified that HUD sought changes to the “statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance.” Specifically, the secretary seeks to compare early defaults and claims by a range of factors including geography, underwriting, or populations served.

I believe the HUD secretary’s request of Congress is too timid. It is in the public interest to empower the HUD secretary, who is overseeing a trillion dollars of taxpayer risk exposure, to use any early-warning indicator that evidence suggests is predictive of losses, provided that its use does not discriminate or otherwise violate the law. When HUD officials know that taxpayers are being exposed to undue risk, it shocks the conscience to say that they must continue to accept such loans for insurance pending administrative procedures and overcoming burdens of proof. We should want FHA staff to be able to continuously refine its early warning indicators, be transparent about the risks that it is seeing, and take steps quickly to adopt new tools as they become available.

I do understand that the implementation of the FHA Compare Ratio, like any other early-warning indicator, will potentially have unintended consequences that do not serve the public’s interest. But it seems to me appropriate to shift the burden of proof, so that it is easier to protect taxpayers

against risk and harder to continue to originate questionable loans for the FHA insurance portfolio.

- **Early-warning risk indicators.** Congress should give the HUD secretary the authority to establish appropriate risk indicators on an ongoing basis and to use these indicators to limit access to participation in FHA insurance programs where these indicators suggest a lender, servicer, or other program participant is more likely to expose the taxpayers to risk. When program participants can overcome a burden of proof that they do not pose undue risk or that a better indicator is available, then FHA's decisions can be subject to scrutiny. But the goal should be to give the taxpayers—not program participants—the benefit of the doubt.

Another concern is that FHA tends to adopt new programs or program changes for its entire portfolio. There are exceptions, of course. FHA did begin to pilot note sales before expanding the program. But too often, unlike private-market participants that will try out a new business practice or insure a small portfolio and test performance before applying a strategy to the whole business, the statutory and regulatory environment for FHA leads to “all or nothing” policy changes. The length of the administrative procedures required also leads to full implementation rather than testing, because an evolutionary or phased change strategy would require iterative regulatory changes and sap so much administrative energy. These practices inherently increase risks to the Fund because new policies go into effect without enough evidence of their likely impact.

- **Risk-reduction pilots—authority to pilot new policies to test their costs and benefits before implementation.** Congress should give FHA express authority to implement pilot programs quickly where the goal is to better understand, measure, and mitigate risk. Full implementation would follow normal administrative procedures. So, for example, FHA could test whether a new alternative underwriting standard (e.g., incentives for pre-purchase counseling), or loss mitigation procedures, or REO disposition approach can achieve program objectives in a cost-effective manner.

Finally, an ongoing concern is whether FHA has the systems, technology, and analytical prowess to reengineer business practices to reduce risk, to understand emerging risks in their portfolio before it is too late, and so on. Giving the HUD secretary authority to hire for risk management, analytic, and technological systems staff on a more generous pay scale could close some of the gap between private-market participants and those charged with protecting the taxpayer from economic harm. Bank regulators are compensated slightly better than other government officials so that the agencies can attract the talent with financial knowledge and analytic skills for effective financial regulation. And regulators can use funds assessed on those they regulate to support the operations, systems, and other needs of the agency to protect taxpayers from losses from insured depository institutions.

- **Allow FHA to hire for select positions at elevated compensation levels to ensure that FHA can attract appropriate insurance, financial, and risk management**

**skills. Also provide FHA with the ability to use insurance premiums for systems and analytical model acquisition to strengthen their capacity to mitigate risk.**

### **The FHA Emergency Fiscal Solvency Act -- H.R. 1145 (2013)**

Originally sponsored by Representative Biggert (R-IL) and passed by the House in 2012 with broad bipartisan support, this bill offers a good opportunity for improved risk management at FHA. However, a few additional authorities still sought by FHA should be included. And three important aspects of the bill should be revised before final passage. In each case, I urge Congress, who is hearing from concerned lender participants in the program, to keep in mind the taxpayer interest. Each time that we place greater burden on the agency before it can take steps to limit lender participation or require lender indemnification, we slow the agency's ability to protect taxpayers. The presumption should be in favor of reducing losses to the government and not allowing lenders to continue originating improperly originated FHA loans at a profit.

#### *Revisions to Section 3: Indemnification by Mortgagees*

Since 2010, HUD has sought to ensure that both direct endorsement (DE) and lender insurance (LI) lenders are liable to indemnify the secretary for losses on loans they originate that do not comply with FHA guidelines. The intent was to provide for equal treatment of both classes of lenders and empower the agency to reduce losses. Currently, FHA can only seek such indemnification from LI lenders. However, as written this legislation would weaken the current authority the agency already has for LI lenders, and it would create additional hurdles to recouping losses by (1) inhibiting FHA from pursuing indemnification from either type of lender until new regulations implementing the DE authority is promulgated, (2) retaining the "knew or should have known standard" for indemnification that the GSEs and other private actors do not use, and (3) requiring a new highly cumbersome consultation process before seeking indemnification.

While the intent of Congress is sound, the current language would impair FHA's ability mitigate losses in a way that private-sector counterparties do not suffer. The current bill's language is an example of how legislative compromise with private-sector program participants seeking more favorable treatment results in prescriptive procedures that cause harm to the taxpayer's interest. The original language sought by the secretary with a streamlined consultation process is a better course.

#### *Revisions to Section 4: Early Period Delinquencies*

FHA's Credit Watch Termination Initiative is designed to allow FHA to use metrics to compare the performance of lenders, focusing attention on those originating loans with a high proportion of serious delinquencies, and allowing them to more easily terminate lenders from the program. As I discussed in my own proposals, I believe FHA should be able to use any appropriate indicator to assess risk by simply making a finding of the evidence of its predictive power, so I recommend this section be modified to provide that flexibility. It is far too cumbersome for the

specifics of the early indicators to be in statute, because—as this process has shown—it can take years to get authority for revisions shown to be necessary to reduce loss.

HUD sought the ability to refine the indicators used so that they could vary by geographic area, underwriting standards, or populations served<sup>7</sup>—which would have accomplished some of the metric flexibility I recommend. However, the current version of this language would be administratively burdensome without providing sufficient additional loss avoidance to justify the level of effort. While I believe broader flexibility to establish the compare ratio and other early warning indicators is justified, at minimum, the definition of early period delinquencies should be revised to be consistent with industry standards: 60 days in default within six months.

#### *Revisions to Section 7: Authority to Terminate Mortgage Origination and Underwriting Approval*

This section, sought by HUD since 2010, would allow FHA to more easily terminate lender authority to originate FHA loans in a specified area or nationwide, if the lender is found to be causing undue losses to the Fund. However, the provision as written in the bill is limited to termination for “early” defaults. FHA should be able to terminate lenders in specified areas whenever their activity causes undue harm to the Fund, whether or not the undue defaults are early.

#### *Further Additions: Authority to Transfer Servicing and Authority to Manage the HECM Program by Mortgagee Letter*

Finally, I note that the most recent report from HUD on the financial status of the FHA MMI Fund 2012 included two new legislative proposals. In each case, I believe that the more general authorities to protect the taxpayer from risk that I propose above would be preferable. However, absent that, the requested provisions would help protect the FHA Fund from additional losses.

The first of these provisions is intended to allow FHA to deal with poor-quality servicing by lenders. The failure of lenders to take appropriate loss mitigation steps can result in higher than necessary claims to the FHA Fund and homeowners losing their homes unnecessarily. This authority will not only deal with ineffective servicers but create a powerful incentive for better servicing.

The second of these provisions would clarify that FHA can manage the HECM program, the origin of significant losses to the Fund in recent years, through mortgagee letter. This change would enable FHA to better respond to the market by implementing structural changes to programs with immediate effect. These changes would eventually be codified through the rulemaking process, and lenders would be able to suggest further modifications through notice and comment periods.

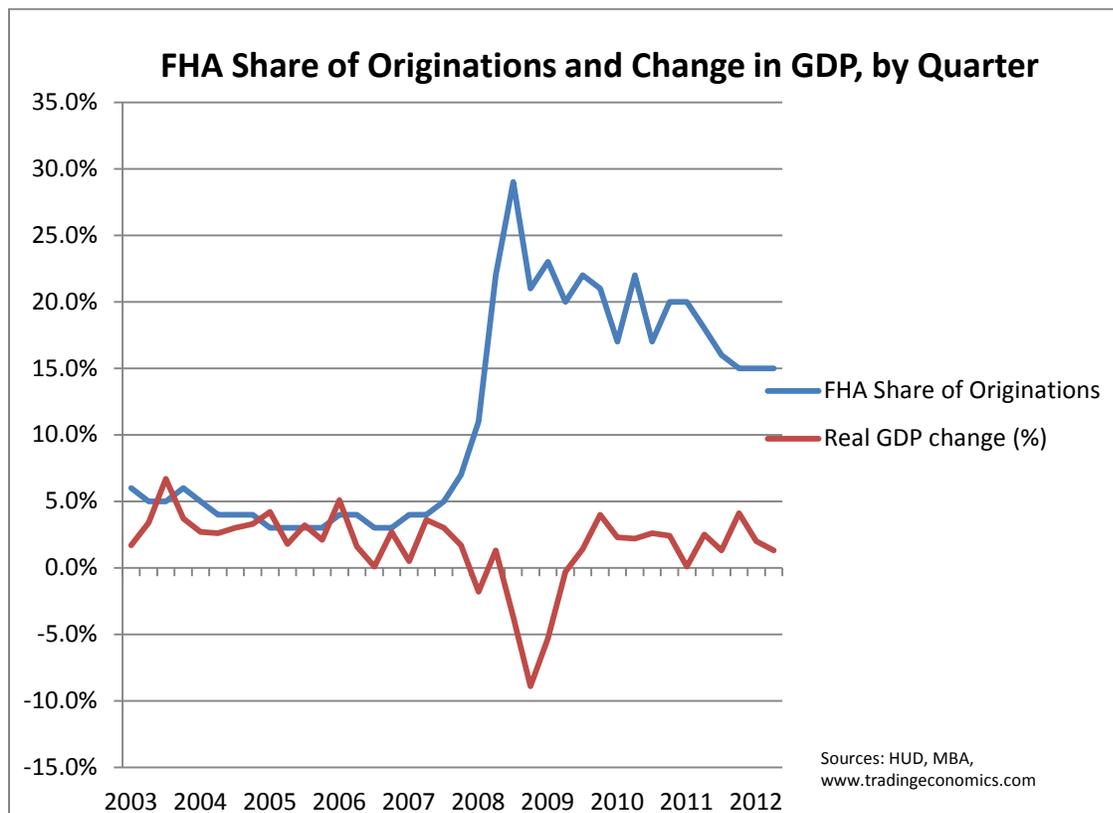
### **Crowding Out? FHA Market Share Is Declining—As It Should**

---

<sup>7</sup> Specifically, in the FY2012 Actuarial, HUD sought the ability to revise the compare ratio.

Some have raised the concern that FHA has crowded out the private sector and that if it withdrew from the market, the private sector would step in. It is, however, difficult to disentangle whether FHA’s higher share is the result of private capital leaving or FHA expanding—the classic “chicken or egg” question. The evidence suggests the former. FHA share grows when the economy is weak and contracts when economic growth returns.

**Figure 1**



There is also ample evidence that FHA is serving a market that other investors do not want. Today, the alternative to FHA is a high-LTV mortgage purchased by the GSEs (not exactly private capital) insured by private mortgage insurers. In effect, the market is segmented between the very safe high-LTV loans that the GSEs and mortgage insurers capture and the modestly riskier loans that FHA insures. In doing so, FHA serves predominantly first-time homebuyers, lower-income households, and minority households that the market otherwise would not serve. The data below highlight a few of the statistics that show this segmentation.

- In 2010, FHA served three times the number of first-time homebuyers (FTHB) as the GSEs.<sup>8</sup>

<sup>8</sup> Szymanoski, E. “The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market.” 13: Exhibit II-1-A. Working Paper No. HF-019 available at [http://www.huduser.org/publications/pdf/FHA\\_SingleFamilyIns.pdf](http://www.huduser.org/publications/pdf/FHA_SingleFamilyIns.pdf)

- In 2010, FHA FTHBs had on average 85 percent of area median income compared with 110 percent for GSE FTHBs.<sup>9</sup>
- In 2010, FHA served far more African American and Hispanic FTHBs than the GSEs did (approximately 210,000 families compared with approximately 70,000 families).<sup>10</sup>
- In 2012, Radian stated in its 10K reports (page 99) that only 1.4 percent of its mortgages had LTVs above 95 percent; in fiscal year 2012, 72 percent of FHA mortgages had above 95 percent LTV.<sup>11</sup>
- In 2012, Radian stated in its 10K reports (page 100) that only 18 percent of its borrowers had FICOs below 680, compared with 43 percent of FHA borrowers in fiscal year 2012.<sup>12</sup>

The above statistics are evidence that much of FHA's current business would not be served by the market in FHA's absence. As the economy continues to strengthen, FHA's share will naturally decline, as it should.

The one way in which I recommend Congress should limit FHA's market share today is to reduce loan limits. By raising the limits when it did, Congress provided support to a mortgage market in disarray, helping to stabilize the economy and support the FHA fund with stronger loans as it played a critical countercyclical role. The need for that support is easing as the housing market recovers in many higher-cost areas. Of course, loan limits should have regional variations to reflect different housing costs, as they have had in the past. And the drop in loan limits should be phased in gradually so there is time for private capital to grow its footprint in higher-value markets. But the time for the transition to normalcy in loan limits is here. What is more, all signs suggest that the Administration and Congress could agree on a reasonable plan to lower limits prudently without delaying broader FHA legislation.

### **Risk-Sharing**

One change to the FHA that has been suggested from time to time is risk-sharing. In 2002, reflecting on efforts of the Clinton administration to pilot single-family risk-sharing for FHA, I wrote a lengthy report as a consultant to the Millennial Housing Commission on the potential benefits and dangers of risk-sharing to FHA's financial health and public purposes.<sup>13</sup>

My thinking today on this topic remains the same: done properly, risk-sharing can be a useful *supplemental* tool to help FHA to better accomplish its mission and find ways to provide credit enhancement in a more cost effective manner. **However, it would be counterproductive to make risk-sharing mandatory for the entire FHA book of business going forward. Such a broad-brush approach runs the risk of "privatizing profits while socializing losses" and would impair FHA's ability to serve underserved borrowers and provide countercyclical credit in times of market stress.**

<sup>9</sup> Ibid, 14: Exhibit II-3.

<sup>10</sup> Ibid, 15: Exhibit II-5.

<sup>11</sup> [http://portal.hud.gov/hudportal/documents/huddoc?id=ar2012\\_forward\\_loans.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=ar2012_forward_loans.pdf) Page 46 Exhibit IV-5

<sup>12</sup> Ibid Page 48 Exhibit IV-6

<sup>13</sup> Sarah Rosen Wartell, "Single-Family Risksharing: An Evaluation of Its Potential as a Tool for FHA," June 2002, available at <http://govinfo.library.unt.edu/mhc/papers.html>.

Risk-sharing means different things with different partners. Sharing risk **with the originator or servicer** could be a way of aligning incentives and improving the underwriting and servicing of the mortgage. Similarly, risk-sharing **with a private mortgage insurer** may improve underwriting to the extent that the mortgage insurer provides a second set of eyes. Nonetheless, alignment of incentives and a second set of eyes are not a substitute for FHA having good risk management practices—that is, knowing itself what risks it is taking, tracking those risks over time, and taking quick action before risks elevate to unacceptable levels.

Risk-sharing of either kind could raise the cost of the mortgage, as private investors will demand a market rate of return. In normal times, this cost may well be worthwhile with the improvement in underwriting and servicing more than offsetting the costs. In times such as those we have recently experienced, where private capital has stood on the sidelines in the parts of the market served by FHA, risk-sharing will significantly raise the cost and, more importantly, limit the availability of credit. Therefore, if risk-sharing is to be used, it should be discretionary with the amount of risk-sharing determined by such factors as the price and willingness of the private parties to bear risk and align incentives. Mandating risk-share formulas in statute would make it difficult to make adjustments to better protect the taxpayer and ensure access to credit continues in times of stress.

In 2002, I offered views on a potential risk-sharing initiative **with one of the government-sponsored enterprises**. In today's environment, with the GSEs in conservatorship, that approach no longer makes sense. However, it is possible that a shared risk initiative might make sense between FHA and a new MBS-level (rather than loan-level) credit insurer in a future housing finance system.

Another idea for single-family risk-sharing would involve sharing risk **with high-performing state and local HFAs**. In 2002, I explored the option at some length:

As risksharing partners, HFAs bring certain key advantages. They share FHA's commitment to public purposes and accountability to the public. They know the affordable housing needs of their communities far better than FHA can from afar. Some are engines of innovation in designing products to meet local needs. They have delivery systems in place, through non-profit and for-profit lenders that originate MRB loans, some of which reach pretty far into underserved communities. Some HFAs also bring sophisticated analytical and operational capacities, although some rely more on their partners for those skills.....

It is easiest to envision how FHA might share risk with state-sponsored mortgage insurance funds – HFA-affiliated operations that provide mortgage insurance, much like FHA. Only a limited number of states have their own insurance funds, but they include a number of large states like California and New York where, for various reasons including high house prices, FHA utilization is limited. However, if a viable model for risksharing with state insurance funds were to emerge, other states might be enticed to create their own state insurance funds to share risk with FHA.<sup>14</sup>

While risk-sharing could reduce the exposure of FHA to mortgage credit risk, it would necessarily increase FHA's or GNMA's exposure to counterparty risk. If the counterparty such as the mortgage insurer or servicer fails and cannot make good on its contractual obligations, the government is still on the hook, as FHA mortgages are securitized by GNMA and carry a full

---

<sup>14</sup> Ibid, at pp. 88-91.

faith and credit guarantee. And loans not eligible for GNMA would not likely find significant capital. Therefore, any risk-sharing arrangement would require that FHA or GNMA monitor the credit worthiness of the counterparties.

In addition to counterparty risk, having another party involved in absorbing the loss could create conflicting interests over loss mitigation strategies that must be managed. Given current issues facing FHA, it would take time and resources to build capabilities around monitoring and managing counterparties. **I recommend that any risk-sharing start small and be kept simple as these capabilities are built.** More generally, the following principles I recommended in 2002 are relevant to guiding any new risk-sharing initiative.

1. **Incrementalism.** FHA must assess its weaknesses and design new products to meet emerging needs, but it should not try to substitute new wholesale products for existing retail products overnight. It should review new products to see if the markets served and performance match expectations. Meanwhile, it should continue to make available its existing products, unless and until it is clear that the needs served today are being better served by alternatives and would continue to do so under different market conditions.
2. **Experimentation.** FHA should test and pilot new approaches. It should try a range of different financial structures, types of partners, types of products, and target markets and learn what works and what does not.
3. **Defining Broad Goals and Providing Programmatic Flexibility.** Policymakers should resist the temptation to prescribe the specific business terms of risksharing agreements (formulas for sharing risk and premium, allocation of responsibilities, oversight mechanisms, etc.) in legislation. Instead, they should establish goals, identify performance measures, and hold FHA accountable for achieving those goals. In return, they should give FHA the flexibility to undertake different approaches to meet those goals and authority to expand those that work and drop those that fail to meet public purposes.
4. **Providing FHA Internal Analytic Capacity.** FHA cannot rely upon a risksharing partner to protect FHA's financial interest and public purposes. For itself, FHA must design and assess agreements against FHA's goals, manage counterparty risk, and analyze the risk it is incurring from the risksharing business and see that it matches the program targets. FHA needs staff with the capacity to undertake these analyses, in consultation with contractors and advisors. FHA needs new employees with sophisticated financial market expertise and skills. Moreover, FHA needs the authority to quickly procure financial advisory services to support FHA in the design, implementation, and monitoring of risksharing agreements and risksharing partners....Congress should make it a condition of risksharing authority that FHA acquires contractor and staff resources for this purpose and Congress should provide it with the authority and financial resources to do so.
5. **Enhancing FHA's Bargaining Power through Competition.** One way for FHA to find partnerships that maximize FHA's objectives is to create competition between potential partners. In some cases, it may make sense for FHA to pilot an approach with a single partner without competition, but, in other cases, partners may be asked to compete for the business opportunity. Statutory language authorizing risksharing should allow FHA to select partners using a variety of mechanisms.

## **Conclusion**

Mr. Chairman, Ranking Member Capuano, and members of the Committee, it is clear that the health of FHA's MMI Fund has suffered because of losses resulting in part from problematic products and processes. Of course, rapidly falling house values due to a persistent economic recession and deep foreclosure crisis were the driving factor. Many of FHA's losses were

inevitable—resulting from FHA’s critical role of ensuring credit flow and availability during recessionary periods. However, it is also clear that better analytic capacity and management tools and the capacity to move more quickly to protect the taxpayer from losses would improve FHA’s ability to manage, price, and mitigate risk and, ultimately, to protect the Fund.

FHA has taken important steps to stem losses where possible in outstanding books of business and to prevent insuring loans that are too high-risk going forward. They seek additional important authorities that would further strengthen the Fund, and I urge Congress to provide them those authorities quickly. But those steps, to my mind, do not seem to fundamentally change the capacity of FHA to act quickly in the taxpayer’s interest, and so I urge Congress to go beyond the revised measures discussed above in the FHA Emergency Financial Solvency Act to the proposals I first discussed above. Clear goals established by Congress, greater data transparency, and more authority to respond rapidly to changing conditions and new insights in order to manage and mitigate risk would go a long way to strengthening the Fund going forward and ensure that FHA does not again become so perilously close to requiring taxpayer support.

At the same time, I urge the Congress to consider FHA’s larger role in the housing finance system only in the context of broader questions about the shape of the housing finance market after the end of the conservatorship of the GSEs. We must not take steps now, absent those larger discussions, that would make it impossible for FHA to continue to play its indispensable countercyclical role and its ever-important mission of ensuring credit is available to worthy borrowers who have limited options in the private market.

Small risk-sharing pilots, operated under the principles I articulated above, are possible in the meantime, once FHA has stabilized the insurance fund and is rebuilding its capital reserves, as a way to explore future roles. But, Congress must not let the opportunity pass to strengthen FHA’s risk-management capacities immediately. Whatever role is assigned to FHA in the long term, we all will be better served if it has the capacity to manage better the risk it takes on in fulfilling that mission.

Thank you.