Testimony to
US House of Representatives
The Committee on Financial Services
on the
FY09 FHA Actuarial Report

By

Ann B. Schnare, PhD
Empiris LLC

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Good morning. I would like to thank the Chairman and Ranking Member for inviting me to speak here today. My name is Ann Schnare, and I am a partner at Empiris LLC, an economic consulting firm. I worked at Freddie Mac from 1993 to 2000, first as Vice President for Housing Economics and Financial Research, then as Senior Vice President for Corporate Relations. Over the years, I have consulted on a number of issues involving FHA, including its financial health. Last year, my colleague Michael Goldberg and I correctly predicted that the Fund would fall below the 2 percent capital threshold by the end of the FY2009.[1]

Let me begin by emphasizing that FHA is playing a critical role in the housing market today. Without its continued presence, the anemic housing recovery would undoubtedly come to a halt, which would have ripple effects on the broader economy.

At the same time, there are clear indications that FHA is under considerable stress, and may in fact be laying the seeds for additional problems going forward. FHA delinquencies continue to rise; the concentration of loans in troubled markets such as California, Nevada and Florida continues to grow; and many FHA mortgages continue to be funded at effective loan-to-value ratios that are close to 100 percent. While FICO scores are also rising, high FICO scores no longer provide the protection that they once did, particularly in an economy with declining housing prices and a 10 percent unemployment rate.

The recently released FHA audit found that the Mutual Mortgage Insurance Fund has run through most of its capital reserves, and no longer meets its mandatory 2 percent threshold. Under the audit's "base case" projections, the capital ratio would be about 0.5 percent—which, given the complexity of the calculations, is effectively zero. Under more pessimistic economic assumptions, the Fund would not have the capital required to meet its projected obligations. Although we have not attempted to replicate the FY2009

[1] Michael Goldberg and Ann B. Schnare, "An Update on the Capital Adequacy of the FHA Single Family Insurance Program," February 9, 2009.

audit, in my view, the base case projections are optimistic, and the Fund is most likely facing a significant capital shortfall.

One of the major shortcomings of the HUD audit is that it does not consider the current delinquency status of loans in projecting their future performance. While this may have been a reasonable simplification in earlier years, the fragile nature of the housing market makes this omission troublesome today.

Mortgage delinquencies have been rising more rapidly than foreclosures for quite some time, creating what some believe is a "foreclosure overhang." A recent report by Amherst Securities found that although the time to foreclosure is lengthening, ultimate cure rates are on the decline—hence, the build up in the number of delinquent loans in the current inventory.[2] Since HUD's analysis bases its projections on claims, as opposed to delinquencies, it may be underestimating future losses in its book.

For example, the actuarial analysis projects that roughly 116,000 loans will default in FY2010. Yet, as pointed out by my colleague Michael Goldberg, there are already about 108,000 FHA loans that are in the foreclosure process, and new foreclosure starts have been averaging about 11,000 per month. Unless one assumes that a high percentage of these loans will cure—which seems highly unlikely—the claim rates projected in the base case would appear to be far too low. In fact, most analysts believe that the overwhelming majority of the loans that are more than 90 days delinquent today will ultimately result in a claim—an assumption that would dramatically change the financial projections for the Fund.

While cure rates can obviously be affected by many factors—e.g., future housing prices, employment trends, and loan modification programs—these data suggest that the FHA is at best running on empty and probably has crossed the line into insolvency.

[2]Laurie Goodman, Outlook For The Housing Market in 2010, Amherst Securities, November 2009

The audit may also understate the impact of the changing geographic distribution of FHA loans. HUD models future house price trends at the national level. In our earlier analysis, we projected housing prices at the metropolitan level, which helped to explain our more pessimistic projections of future performance. Given the rising concentration of loans in troubled markets such as California, HUD's approach may be underestimating both the incidence and severity of future losses.

Finally, the economic assumptions that underpin the audit may prove to be overly optimistic, particularly as they relate to house price trends in 2011 and beyond.

Recommendations

In the short-term, I believe that there are at least four things that FHA can and should do to improve the current situation.

The first is to make the financial condition of the FHA program more transparent. Waiting another year for the next FHA audit is unacceptable in this volatile economic environment. Projections should be updated on a quarterly basis to reflect changing economic conditions and forecasts. FHA also needs to provide more meaningful reports on the on-going performance of its loans. Right now, the costs of obtaining the information required for an independent assessment of the likely performance of the FHA book are far too high. Better reporting on the risk characteristics and performance of its loans should become a priority for FHA, and the reports should be made available to the public. If nothing else, such disclosure will help to calm the fears of many observers who worry that FHA is assuming too much risk.

Second, FHA should increase its downpayment requirements, particularly in markets which are continuing to suffer house price declines. While FHA borrowers are required to put 3.5 percent down, they are also allowed to finance the up-front premium and a portion of their closing costs. The net result is that many FHA borrowers are in a zero or even negative equity position the moment they move into their homes. This dramatically increases the risk of foreclosure, particularly in a bad economic environment and a weak or declining housing market.

One thing we've learned from the current crisis is that relaxed underwriting can be bad for borrowers and destroy neighborhoods. Does it really make sense to originate 100 percent LTV loans in markets with declining housing prices? FHA needs to tighten its underwriting standards to ensure that its loans perform.

Third, FHA should begin to recapitalize the Fund by enacting a modest increase in its insurance premiums. In my view, increasing the up-front premium is not the way to go. Since the up-front premium is non-refundable, this would tend to penalize borrowers who may have to move as a result of a change in job or family status. If the up-front premium is financed, it would also reduce the borrower's equity in the home. As a result, I believe that recapitalization should be accomplished through an increase in the annual premium.

When we looked at the issue a year ago, we found that a 20 to 25 basis point (bps) increase in the premium would have allowed the Fund to meet its statutory capital requirement in FY2009. While we have not updated our analysis, we believe that something along these lines would be appropriate today. The path is admittedly difficult—a large increase could defeat the purpose and lead to further house price declines. However, current FHA pricing is out of sync with that available through the GSEs and private mortgage insurers, and needs to be re-examined.

Fourth, FHA needs to audit every loan that defaults within the first 12 months. Such "early payment defaults" typically stem from shoddy underwriting practices or outright fraud. Rather than routinely paying the claims, FHA should take steps to ensure that all applicable guidelines have been met, and crack down on offending lenders. The number of FHA originators has increased dramatically in the past two years, and there are anecdotal reports that many subprime brokers have simply switched their outlet to FHA, bringing their fraudulent practices with them. The provisions contained in HR 3146 are an important step in the right direction.

Finally, in the longer term, the role and structure of FHA needs to be reconsidered within the broader context of financial reform. FHA has long been plagued by resource constraints, an inability to attract and maintain qualified staff, and lack of autonomy. Its activities and practices are not subject to the same level of scrutiny as the GSEs, although the risks it assumes are as great, if not greater. Going forward, it is critical to give FHA the resources, flexibility and oversight that it needs to accomplish its public purpose while maintaining the integrity of the Fund. FHA's role in relationship to the GSEs also needs to be reconsidered.

Fortunately, while the stakes are high, I believe we have the right people in place to guide FHA through these difficult times. Both Secretary Donovan and Commissioner Stevens understand the housing market and the mortgage business. They have already taken steps to improve risk management controls and return to quality underwriting, for example, by appointing a Chief Credit Risk Officer and increasing capital requirements for loan originators. These actions should be applauded. However, they are the beginning, not the end. I sincerely believe that if we wait another year for FHA's next financial "check-up," the results could prove disastrous.

In closing, I would like to again thank you for inviting me to this hearing today, and giving me an opportunity chance to express my views. I am a long-time supporter of both FHA and affordable lending. I hope that my comments can make a positive contribution to your deliberations.