TESTIMONY

Future Role of FHA and Ginnie Mae in the Single-Family Mortgage Markets

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Insurance, Housing and Community Opportunity Subcommittee of the Committee on Financial Services

United States House of Representatives

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It is an honor to appear before this Subcommittee today to testify on reform of the Federal Housing Administration (FHA) single-family mortgage insurance program and of the Government National Mortgage Association (Ginnie Mae). I am Basil N. Petrou, managing partner of Federal Financial Analytics, a firm which provides consulting services on, among other things, the array of policy issues affecting single-family residential mortgage finance.[1]

As the Subcommittee knows, these issues are perhaps the most important challenge for this vital sector of the U.S. economy. Numerous policy, regulatory and private-sector errors contributed grievously to the boom in mortgage finance and, now, to the bust in this sector that has led to virtual complete government control. Righting the balance between taxpayer support and private capital is in my view the most critical challenge that must be addressed to restore a vibrant, prudent and stable financial system for single-family mortgages through the origination and securitization chain.

All too often, advocates suggest that private capital will take charge of residential-mortgage finance if Fannie Mae and Freddie Mac are privatized or otherwise forced out of the market. This, though, will not occur if the FHA and Ginnie Mae are left as is. Reform of the

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

government-sponsored enterprises (GSEs) without parallel and companion efforts to restructure the FHA and Ginnie Mae will not reduce taxpayer risk, but only shift it and, perhaps, exacerbate it because of the full-faith-and-credit backstop accorded FHA.

I thus would like at the outset to commend the Subcommittee for its attention to the urgent question of FHA and Ginnie Mae reform. It is my hope that the Subcommittee quickly advances the legislation proposed in conjunction with this hearing, bearing in mind the specific recommendations I shall offer in the body of this statement. In summary, I urge the Subcommittee to:

Ensure the Return of Private Capital to U.S. Mortgage Finance

Much is said of the need for private capital, but many policy recommendations seemingly aimed at this goal in fact would undermine it. An example is the pending inter-agency proposal to implement the risk-retention requirements mandated by Section 941 of the Dodd-Frank Act.[2] Because the law excepts FHA and the rule would impose stringent risk-retention requirements on all mortgages with downpayments of less than twenty percent, low-downpayment lending will flow to the FHA. This is contrary to Congress' stated intent in the Dodd-Frank Act and the goal of the Subcommittee's new FHA-reform proposal.

Balance FHA/Ginnie Mae Reform with that of the GSEs

This Subcommittee has jurisdiction only over the legislation before it, but the proposal comes of course in tandem with Committee efforts to rewrite the GSEs. The Administration

[2] 76 Fed. Reg. 24090 available at http://edocket.access.gpo.gov/2011/pdf/2011-8364.pdf.

has rightly focused on implementing a "wind-down" strategy for the GSEs in concert with changes to the FHA so that the U.S. residential-mortgage secondary market does not become the sole province of entities backed directly or indirectly by the taxpayer. As FHA reforms in areas like pricing and loan limits advance, so too should those for Fannie Mae and Freddie Mac.

The draft legislation considered today is a vital first step towards a newly-rebalanced policy on mortgage finance. Key provisions in it that I support include:

- the increase in the minimum borrower downpayment to five percent, which – when combined with the prohibition against the financing of closing costs – will increase the "skin in the game" contributed by borrowers. These requirements will not adversely affect first-time or low- and moderate-income home buyers, but they will provide better discipline for prudent mortgage origination and sustainable home ownership;
- the elimination of the FHA national loan-limit floor, which will rightly refocus FHA on the segment of the market suitable for first-time and low- and moderate-income buyers;
- the establishment of minimum FHA mortgage insurance premiums, essential to rebuilding the solvency of the FHA and, thus, to reducing taxpayer risk; and
- improvements in the powers of the FHA to terminate or discipline lenders and to require indemnification from them.

However, it is vital to connect the first set of issues I have noted – the need for real private capital and a balanced role for the U.S. Government – with the specific objectives addressed in this legislation. To do so, I recommend not only enactment of the provisions noted above in this bill, but also legislation and policy changes to:

- modify the 100 percent full-faith-and-credit guarantee provided by the FHA for all loans it insures. It's simply impossible for there to be real incentive alignment between originators and the U.S. taxpayer if originators take all the profit and the U.S. taxpayer takes all the risk. Further, the full-faith-and-credit backstop distorts the U.S. financial system and global capital markets because capital regulations and many other provisions strongly favor obligations of this sort over those backed by private capital, creating a high barrier to the re-entry of private capital to U.S. residential-mortgage finance;
- allow FHA to share risk with private capital, perhaps beginning with limited programs to ensure that risk shares are indeed robust and that price appropriately reflects this risk share instead of providing a back-door subsidy that permits a resumption of risky loan-origination practices; and
- target the FHA to borrowers based on income, not home price. Currently, high-income borrowers are often eligible for full-faith-and-credit U.S.-backed mortgages even though the private market for their mortgages would otherwise be deep, liquid and efficient. When the U.S. Government supports mortgage finance for higher-income borrowers, it supplants private capital otherwise ready to take on this risk.

In the balance of this testimony, I will address each of these specific issues in detail.

Borrower Downpayments Can and Should be Increased as Proposed

The Subcommittee legislation would:

- increase the minimum downpayment from 3.5 percent to five percent of appraised value; and
- disallow any initial service charges, appraisals, inspections or other closing costs from the financed amount.

Current FHA policy combines a low nominal downpayment with authority to include significant closing costs in the financed amount as well as the upfront FHA insurance premium. While the payment of closing costs cannot be used to meet the 3.5 percent minimum downpayment requirement, the fact that closing costs can be included in the financed loan amount means that the borrower starts with a 96.5% initial loan to value calculation before consideration of seller contributions and the financed upfront FHA premium.

In a world of unstable house prices, beginning ownership with a bare minimum 3.5 percent equity interest in a house means that the borrower is vulnerable to even relatively slight house price reductions. If house prices fall, first-time buyers will see their equity wiped out very quickly. This is of course highly problematic for borrowers, for their communities and for the solvency of the U.S. mortgage-finance system.

First, it leaves borrowers at risk for even small adverse events like broken pipes, let alone enabling them to undertake the significant improvements often required at FHA-financed properties where home-inspection and/or appraisal processes have been rightly called into question. If a borrower were to lose his or her job and need to move to a new location, the combination of even a slight decline in house prices plus the transaction costs needed to sell the house means the borrower will not be able to pay off the FHA mortgage from the proceeds from the sale of the home.

In the past, borrowers often were persuaded that owing more than the house is worth was warranted because house-price appreciation will simply make up the difference. Of course, to obtain cash from house-price appreciation requires refinancing a mortgage, which borrowers all too often did through products that undermined sustainable home ownership instead of enhancing it. Hopefully, those products are gone and will not reappear. However, as a government program, FHA should assume as its top priority putting first time homebuyers into homes they can afford to keep.

However, neither the FHA nor other pending policy initiatives should demand such high downpayments that home ownership becomes prohibitive for many Americans and housing-market recovery is placed in still greater jeopardy. The inter-agency proposal noted earlier to implement Section 941 of the Dodd-Frank Act specifies that a "qualified residential mortgage" (QRM) exempt from risk retention would need to have at least an twenty percent downpayment and does not permit offsetting this requirement through the use of private mortgage insurance (MI). This proposal would gravely undermine the Subcommittee's goal of a targeted, prudent role for the FHA because all too many eligible borrowers for low-risk mortgages will be frozen out of the private mortgage-finance system. Many families who bought during the market boom have lost equity in their existing homes. These low downpayments, repeat buyers and first-time homebuyers who need private, low-downpayment options are a large part of the current housing market and are critical to the housing recovery. The National Association of Realtors estimates that 75 percent of all buyers – first-time buyers and repeat buyers – financed eighty percent or more of their home purchase in 2010.[3]

Thus, it is vital to balance downpayment requirements to promote the goals of sustainable home ownership, an appropriate role for the FHA and the recovery of the U.S. mortgage market. In my view, the legislation's proposed five percent minimum downpayment and financing-amount restrictions do so, while the pending QRM rule would undermine any hope of an appropriate balance or near-term recovery in the housing market.

The FHA national loan limit floor should be eliminated.

Currently, FHA is authorized to insure a loan equivalent to 115 percent of the median house price in an area, subject to two restrictions. First, a national loan limit floor has been set at 65 percent of the GSE loan limit. Today, FHA can insure a loan if the insured amount is less than or equal to $271,050 and it does not exceed 115 percent of the median house price in the geographic area.

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[3] National Association of Realtors, *Profile of Home Buyers and Sellers 2010* (Nov. 2010), p. 71, Exhibit 5-3, *available at* http://realtor.org.

Home prices have fallen across most of the country in the past few years and the current FHA national loan limit floor is thus at least sixty percent higher than the national median existing house price, which (according to the National Association of Realtors) has been stable for the last three years at between $160,000 and $170,000.[4] The FHA national loan-limit floor is even higher than the median existing house-sale price for most counties in California – considered the highest cost area of the country -- and it is just slightly below the median sales price in metropolitan Los Angeles.[5] Thus, the current FHA national loan-limit floor means that, for entire states, the FHA is insuring loans that are well above 115 percent of the area median house price in that state and well above the mean for even middle-income homebuyers. The FHA national loan limit floor set at this level effectively guts the FHA's mission of targeting low- and moderate-income borrowers, permitting the U.S. to back borrowers with the highest incomes in their local areas and driving out the private capital that would otherwise support these mortgages.

The pending legislation rightly eliminates the national loan limit floor. Instead, the FHA would be allowed to insure only mortgages at 125 percent of the median house price in the county in which the property is located. This county-of-location approach eliminates the current upward-price bias in determining the relevant "area" which now looks to the highest-priced county in a metropolitan statistical area.

[4] See National Association of Realtors press release on May 19, 2011 entitled *April Existing Home Sales Ease*, which notes the national median existing house price sale in April was $163,700.
[5] See press release and attachment from the California Association of Realtors dated May 16, 2011 and entitled *April 2011 Sales and Price Report.* The press release notes that the statewide median price for a single family detached house was $293,570, the median price in the Los Angeles metro area was $277,300 and that the median price in 22 California counties was below $271,050.

Further, the bill would reduce the allowance over the national loan-limit floor for "high-cost" areas. Now, this is set at 175 percent of the GSE loan limit ($729,750); the bill would reduce this to 150 percent of the GSE limit, meaning that FHA could insure loans of no more than $625,500. This contributes to a return of the FHA to its proper focus although, as discussed below, I believe FHA should be still more tightly circumscribed to the appropriate role for the federal government: insuring only mortgages that meet income-based targets that focus the program on low- and moderate-income borrowers.

<u>The FHA Annual Premium Should be No Less Than 55 Basis Points.</u>

Under the pending legislation, FHA would be required to charge an annual insurance premium of no less than 55 basis points and no higher than 150 basis points. This changes current law, which permits (but does not require) the FHA to charge an annual premium and sets the maximum -- but not the minimum -- amount of the premium. The bill would thus direct that the premiums not be an option, but rather become a requirement, thus helping to rebuild the FHA single family fund.

To be sure, The Department of Housing and Urban Development (HUD) in April set new premiums that reflect the need to rebuild the Mutual Mortgage Insurance (MMI) Fund. However, there is no guarantee absent statute that HUD policy going forward will always reflect this critical discipline. Reducing the annual premiums below 55 basis points would jeopardize the MMI Fund, which is barely meeting its statutory capital requirements. This was most recently made clear by the Congressional Budget Office (CBO), which last week concluded that a fair-value analysis of the MMI Fund shows that the Fund has a negative capital ratio – in sharp contrast to the positive balance now reported under federal budgeting procedures.[6] Congress should ensure that it carefully reviews any future "price-cutting" by FHA so that the MMI Fund is not placed at risk for "marketshare" or similar objectives that might again determine FHA policy.

Congress Must Enhance FHA and Ginnie Mae Efforts to Improve Risk Management

The proposed legislation would allow the FHA to require a lender to indemnify it if the Secretary of HUD determines that a loan was not originated or underwritten in accordance with FHA standards and FHA has paid an insurance claim. Additionally, the bill would authorize HUD to demand indemnification in cases of fraud or misrepresentation even if a claim has not been paid. This authority is comparable to that now exercised by private mortgage insurers, who rescind insurance when relevant terms and conditions are not met.

Private insurers do this because paying claims on loans originated without compliance with set standards or, worse, in fraudulent or similar cases is akin to paying claims for fire damage caused by arson. This is not proper insurance policy for the private sector and it is just as risky for FHA as a government program.

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[6] See letter dated May 18, 2011 from Douglas W. Elmendorf to Congressman Paul Ryan with attachment entitled Accounting for FHA's Single-Family Mortgage Insurance Program on a Fair-Value Basis. The letter notes that under the Federal Credit Reform Act of 1990 the FHA MMI Fund produces budgetary savings of $4.4 billion in FY 2012 but on a fair value basis the program would impose a budgetary cost of $3.5 billion.

Finally, the legislation would create a Deputy Assistant Secretary of HUD for risk management at the FHA and mandate a chief financial officer (CFO) at Ginnie Mae. Both of these positions are needed and the legislation rightly ensures that they are established and maintained to enhance ongoing efforts to improve internal controls at these agencies. Similarly, the bill requires the Secretary of HUD to conduct an examination of FHA programs to improve their efficiency, requiring a report to Congress on recommendations resulting from this examination within one year of enactment. FHA has programs long in existence without demonstrable result, and this review will ensure the ground-up analysis required to focus FHA on its vital role of ensuring sustainable home ownership for low- and moderate-income borrowers.

Congress Should Provide FHA with More Pilot Program Flexibility

In conclusion, I would like to suggest to the Committee a few additional legislative changes to the FHA which would allow FHA to initiate pilot programs to test the best way to alter its future activities to better serve low and moderate income borrowers and to protect the taxpayer. Pilot programs should be authorized as follows:

- Instead of targeting house price, the FHA should be allowed to target borrower income as it relates to the median family income in the metropolitan statistical area in which the house is located. The advantage of this approach is that it sharply limits gaming of the FHA loan amounts in future years as median family income in an area fluctuates far less than median house price over time. It also allows the effect of changing mortgage interest rates on qualifying borrowers to be factored into FHA loan exposure. This approach does not need to be uniform nationwide. Some areas could have the limit set at 125% of median family income to reflect their lower rate of home ownership, while other areas with high homeownership rates could have the income limit set at 85% of median family income to address homeownership needs of low and moderate income families in that area.

- FHA should insure less than 100 percent of the loan amount where appropriate. Indeed, the MMI Fund would be far healthier over time if the borrower and lender both were required to have more "skin in the game." The current VA program is an example where less than 100% coverage (VA coverage starts at 50% for lower loans amounts and falls as the loan amount increases) is currently implemented with Ginnie Mae. Congress could have FHA insure thirty percent of a loan amount in areas where there is already a high homeownership rate and where borrower incomes are sufficient to meet housing needs. However, in those inner-city areas where homeownership is low and house prices are uncertain, the FHA could insure 85 percent of the loan amount to provide lenders with an incentive to advance funding.

- FHA should experiment with risk sharing programs with the private sector. FHA currently has authority to enter into a risk share pilot program with private insurers where the insurer reinsures the FHA risk.[7] This authority should be amended to allow FHA to experiment with risk sharing where the private insurer takes a first-loss position and the FHA assumes a second-loss one or partially reinsures the private coverage. These approaches would significantly reduce taxpayer risk resulting from the FHA both due to the direct risk-absorption provided by private capital and through the significant, if indirect, benefit of having private capital at risk provided through an independent second underwriting of the loan. This would sharply enhance the risk-management discipline FHA is seeking that the pending legislation also would promote, but it would do so through capital at risk, not new offices or internal procedures that must be carefully followed and fully implemented to have any real effect over time.

[7] 12 USC 1725z-14.

United States House of Representatives
Committee on Financial Services

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Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.

1. Name:	2. Organization or organizations you are representing:
Basil N. Petrou	Federal Financial Analytics, Inc.

3. Business Address and telephone number:

[redacted]

4. Have <u>you</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	5. Have any of the <u>organizations you are representing</u> received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?
☐ Yes ☑ No	☐ Yes ☑ No

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