



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410

Written Testimony of Assistant Secretary for Housing and Federal Housing Administration Carol Galante
Hearing before the House Financial Services Committee

Wednesday February 13, 2013

Chairman Hensarling, Ranking Member Waters, and Members of the Committee, I appreciate the opportunity to appear today before the Committee to discuss the financial condition of the Federal Housing Administration, including the annual report on the Mutual Mortgage Insurance Fund (MMIF).

We are in an important phase of the recovery of America's housing markets. As 2013 begins, though there are regional variations, there are a number of encouraging trends that indicate that our economy in general and housing in particular, are moving in a positive direction. The number of families falling into foreclosure is half what it was in the early days of 2009. Housing construction is growing faster than at any time since 2008 and this has been the strongest year of home sales since the crisis began. In addition, increasing home values lifted 1.4 million families above water in 2012. While there is still a long way to go, these indicators suggest that the housing market is continuing to improve in a manner that will contribute positively to the overall economy.

On the other hand, despite these positive developments, it is still clear that the recovery is fragile, and there are a wide range of factors that could limit the progress that is taking place. Accordingly, we must remain focused on our efforts to restore the housing markets and assist families in returning to prosperity while also taking steps toward a new era of housing finance in this country.

I. Overview of Findings of the Independent Actuary with Regard to FHA's Single Family Programs

It is with this context in mind that I now want to turn to a discussion of FHA's single family programs. Much of the progress that we are seeing in the housing sector has been possible because of the FHA, which has provided access to homeownership for millions of American families and without which the crisis would have been much deeper. In fact, Moody's Analytics estimates that were it not for FHA's presence during the crisis, house prices would have fallen 25 percent further than they did already.

FHA's contribution has not been without stress, however. On November 16, 2012, HUD delivered its fiscal year (FY) 2012 Report to Congress on the Financial Status of the FHA Mutual Mortgage Insurance Fund, which is used for FHA's single family programs. That report summarizes the results of the independent actuarial review conducted by Integrated Financial Engineering (IFE) and provides a status

report on the fiscal health of the MMI Fund. Via its review, the actuary measures the economic net worth of FHA's portfolio at the end of the fiscal year— essentially, the total value of the portfolio after FHA pays all expected claims for the next thirty years in a run off scenario where no new loans are insured, based on an independent, commercially available, economic forecast. This economic value is then divided by the total value of the MMI Fund's insurance in force to derive an estimated capital reserve ratio for the Fund. According to the latest findings of the independent actuary, which Secretary Donovan testified about before the Senate Banking Committee on December 6, 2012, in FY 2012 the capital reserve ratio of the Fund fell below zero to negative 1.44 percent, and the Fund's economic value stands at negative \$16.3 billion. Books of business originated from 2007-2009 continue to be the prime source of stress to the Fund, with fully \$70 billion in claims attributable to these books of business alone. In contrast, the actuary attests once again to the high quality and profitability of books insured since 2010. Thus, this year's report shows that even though our books of business insured since 2010 are the strongest in agency history, there is still work to be done in mitigating the impacts to the Fund of losses stemming from older books of business which were most severely impacted by the recession and other risk factors, such as seller-funded down payment policies. Toward this end, a series of aggressive measures FHA will take in this fiscal year is discussed later in this testimony.

While the actuary's finding regarding the economic net worth of FHA's portfolio is obviously of very serious concern, it is not the determining factor for whether FHA will need to draw on permanent and indefinite budget authority from the Treasury. Any determination that such a draw is necessary will not be made until the end of FY 2013, and in any event, does not affect the full faith and credit of the Federal Government to pay any claims. In the intervening period, the President's budget will outline the Administration's expectation of whether or not FHA will need assistance by the end of the fiscal year. However, the ultimate need will be borne out in the actual performance of the FHA single family program over the course of the fiscal year, and will be impacted by the steps FHA takes over the course of the year to increase revenue or reduce losses.

While the magnitude of the figures involved in this year's budget re-estimate are large, as an example, the President's FY 2012 budget submission, issued in February of last year, anticipated that FHA would need to draw nearly \$700 million in assistance from the U.S. Treasury, as provided for under the Federal Credit Reform Act, to cover expected claim obligations. Instead, at the end of FY 2012 the Capital Reserve Account held \$3.3 billion – even after setting aside the necessary funds to cover the increase in expected costs over the prior year. The fact that the MMI Fund ended the fiscal year with this balance is due primarily to policy changes made during FY 2012 that substantially improved the value of the Fund. Likewise, the series of additional changes FHA has announced and which are described below are designed to reduce the likelihood that FHA will need to draw on Treasury assistance at the end of FY 2013.

Secretary Donovan and I will continue, as we have throughout this Administration, to be diligent in taking every action appropriate to protect taxpayers while continuing to ensure that FHA supports the stabilization of the housing market, and that families have access to sustainable mortgage credit options.

II. The Role of FHA's Programs in the Nation's Housing Finance System

As we discuss the current status of FHA's programs and finances, it is important to frame this discussion within the context of the role FHA has played historically in the nation's housing finance system. Throughout its history, FHA has supported access to affordable, sustainable mortgage financing to

persons and entities underserved by the conventional market. Through its single family, multifamily and healthcare loan guarantee programs, FHA has acted as a stabilizing force in the housing market during times of economic distress. At no time has this countercyclical influence been more pronounced than during the recent housing crisis. In the face of ongoing challenges in these sectors, FHA has continued to provide access to mortgage finance opportunities during a period of severe constriction in conventional markets. As a result, FHA has played a central role in bringing the housing market from the brink of collapse to a place where the outlook is positive and improving.

Since its inception in 1934, FHA has provided access to homeownership through its single family programs for credit-worthy lower wealth or otherwise underserved borrowers, enabling more than 40 million families who might otherwise have been denied access to credit to realize the American dream of homeownership. In addition to providing access to financing for credit-worthy borrowers by insuring mortgage lenders against losses on defaulted loans, FHA's single family programs have also offered crucial liquidity in the mortgage finance system during periods of market stress. Whether providing ongoing credit availability in areas experiencing regional recessions, or ensuring nationwide liquidity during broader economic crises such as we have recently experienced, FHA has repeatedly acted as a vital stabilizing force in the single family mortgage market when constriction in conventional lending threatens effective functioning of the market.

Likewise, FHA's multifamily and healthcare programs have been very important to facilitating credit availability in their respective sectors. These programs provide critical mortgage financing opportunities that strengthen communities by addressing specialized financing needs including insurance for loans to develop, rehabilitate and refinance multifamily rental housing, nursing home facilities and hospitals. These sectors faced a severe contraction in the availability of conventional financing, as well as a near collapse of the tax exempt bond market, making FHA's programs essential. FHA multifamily and healthcare mortgage insurance programs operate under FHA's General Insurance-Special Risk Insurance (GI-SRI) Fund, which is separate and distinct from the MMI Fund used for single family programs.

III. FHA Single Family Programs

Created in the aftermath of the Great Depression and designed to expand access to homeownership that would in turn stimulate the ailing residential housing markets, FHA played a central role in developing today's mortgage finance system. It redefined mortgage underwriting practices so that qualified borrowers could obtain mortgage financing, and it standardized construction and appraisal requirements so that mortgage contracts could be tradable across the country. Even more important than FHA's contribution to developing modern mortgage standards and practices, however, has been its role as a countercyclical force that ensured continued liquidity throughout the mortgage finance system during periods of economic stress. This has been true on a number of occasions at the regional level as FHA has offered support for mortgage financing in specific geographies experiencing localized recessions. For example, in many communities affected by the oil patch crisis of the 1980s FHA played a vital part in keeping credit flowing and regional real estate markets from shutting down entirely. And never has FHA's ability to act counter cyclically been more important than during the recent housing crisis, when FHA played a very prominent role in stabilizing the housing finance system and averting a total collapse of the housing market. By design, FHA's programs are meant to complement, not supplant, private capital. They are there to combat a lack of available mortgage credit when private capital retreats or underserves markets, and to step back when private capital returns or expands to serve previously underserved populations. And because of this unique role, its business cannot and should not be evaluated on the same terms as a private firm, as such a requirement would force FHA to

act as a private firm and therefore eliminate its value in providing countercyclical liquidity and credit to underserved markets.

A. FHA Single Family Activity in FY 2012

In 2012, FHA continued to play an important part in the ongoing recovery of the nation's housing market and broader economy. FHA insured nearly 1.2 million single-family forward mortgage loans during the fiscal year, with a total dollar value of approximately \$213 billion. Of the over 700,000 thousand home-purchase mortgages endorsed during the year, 78 percent were for first-time homebuyers, reaffirming FHA's role in providing access to new entrants to the home ownership market. Indeed, over the past four fiscal years, FHA has insured mortgages for over 2.8 million first-time buyers.

FHA also continued to be a vital source of home financing for minority borrowers. While FHA insurance was used for approximately 27 percent of all home purchase mortgages in 2011, FHA accounted for 50 percent of home purchase mortgages for African American borrowers. For Hispanic and Latino populations which, according to the National Association of Hispanic Real Estate Professionals are expected to account for 40 percent of the estimated 12 million new household within the next 10 years, 49 percent use FHA to access homeownership.

Clearly, FHA has played a very crucial role in facilitating continued liquidity in the single family mortgage finance market, preventing even more severe economic circumstances during the recession. As Moody's Analytics Chief Economist Mark Zandi said in a Washington Post article¹, "If FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it." Moody's estimates that were it not for FHA's presence during the recent crisis, house prices would have fallen an additional 25 percent, resulting in 3 million more job losses and a reduction of economic output of \$500 billion.

Although FHA continues to be an important source of access to credit for American families, its market share continues to decrease as the economy recovers and private capital begins to return to the market. New insurance endorsement activity in FY 2012 fell once again from that of the prior year, continuing its decline from the peak levels seen in FY 2009. As a percentage of total market share, refinance and purchase transactions, FHA represents 14.6 percent of the nation's mortgage market. In terms of dollars of single-family loans insured, 2012 is the lowest volume since the start of the crisis. Indeed, FHA's volume by loan count is now at levels seen in 2002 and 2003 when it's market share was smaller than today. Thus, FHA's current market share is more indicative of the reduction in the total size of the market than it is of abnormal levels of FHA activity.

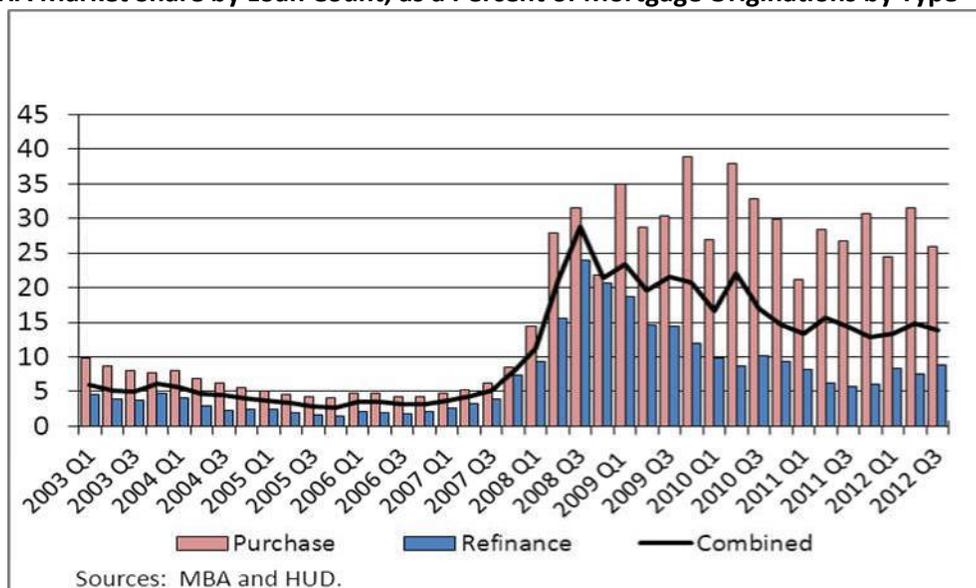
Home Equity Conversion Mortgage (HECM) insurance endorsements in FY 2012 were also down by 25 percent from FY 2011 levels, to 54,591 loans. FY 2012 marks the third consecutive year in which HECM volume declined, as the combined effects of policy revisions to the product and changes within the industry have reduced participation in the program.

¹ Zandi, Mark. (2012, September 28). Obama policies ended housing free fall. *The Washington Post*. http://www.washingtonpost.com/realestate/obama-policies-ended-housing-free-fall/2012/09/27/20635604-0372-11e2-9b24-ff730c7f6312_story.html

FHA and Overall Market Originations by Loan Type						
	FHA			All		
	Purchase	Refinance	All	Purchase	Refinance	All
2003	629,919	638,542	1,268,461	7,426,006	15,677,677	23,103,684
2004	457,404	237,995	695,399	6,904,911	7,966,749	14,871,660
2005	322,915	133,261	456,176	7,233,456	7,251,637	14,485,093
2006	295,261	115,859	411,120	6,563,679	5,765,899	12,329,578
2007	317,181	211,093	528,274	5,222,266	5,071,725	10,293,991
2008	844,893	560,767	1,405,660	3,508,103	3,583,680	7,091,783
2009	1,088,356	896,558	1,984,914	3,338,302	6,052,223	9,390,525
2010	944,159	518,571	1,462,730	2,925,707	5,432,837	8,358,544
2011	759,386	312,385	1,071,771	2,864,629	4,774,054	7,638,683
2012	724,315	534,780	1,259,095	2,779,974	5,858,193	8,638,167

Source: HUD Estimates of Market Data and FHA Single Family Data Warehouse

FHA Market Share by Loan Count, as a Percent of Mortgage Originations by Type



FHA served an important and necessary role in the nation’s housing finance system throughout 2012. Because of the agency’s importance to the overall health of the housing market and its responsibility to American taxpayers, FHA constantly seeks to balance efforts to provide access to credit for underserved borrowers and ensure continued liquidity in the system with its responsibility to prudently protect the health of the MMI Fund. Throughout the current Administration, we have continually sought such balance in establishing policies and practices for FHA.

B. The Mutual Mortgage Insurance Fund

The important services FHA single family programs provide to the nation's housing sector are made possible through FHA's Mutual Mortgage Insurance Fund. The MMI Fund operates with two primary sets of financial accounts:² a Financing Account, which reflects the business transactions related to insurance operations, and a Capital Reserve Account, which reflects secondary reserves to cover unexpected increases in program costs, including higher claim expenses, or lower fee collections. Both of these accounts are held at the U.S. Treasury. The Capital Reserve Account was established to assist in managing to the two-percent capital ratio requirement enacted by Congress in 1990. FHA's MMI Fund programs, however, are backed by the full faith and credit of the U.S. Government like all federal government direct-loan and loan-guarantee programs, its financing account operates with what is called "permanent indefinite budget authority" under the Federal Credit Reform Act to cover unexpected increases in program costs. This authority provides access to the U.S. Treasury for any funds needed to pay claim obligations, and provides assurance to lenders and investors that FHA programs are never in jeopardy of lacking sufficient funds to pay insurance claims. That would be true even in the absence of a Capital Reserve Account.

The Fund is subject to two distinct portfolio valuations each year. Both project all future revenues and expenses based upon a forecast of loan performance under defined economic conditions. One is performed by an independent actuary in accordance with requirements of Section 202 of the National Housing Act, and included in the FHA financial statement. The other is the annual subsidy re-estimate performed by the Administration under the terms of the Federal Credit Reform Act and published in the President's Budget.

The independent actuarial study uses statistical models to develop 30-year projections of default, claim, loss-on-claim, and prepayment rates on current and future books of business. Those models are estimated using historical patterns of FHA-insured loan performance under a wide variety of economic conditions. They are applied to active loans, and they use commercially-available forecasts of home prices and interest rates to predict loan performance in the future. The resulting projections determine business-operation cash flows needed to estimate the economic value of the Fund.

In 2012, the actuarial study applied a stochastic method to estimate the net present value (NPV) of future cash flows, implementing recommendations by the GAO and the HUD OIG. In previous studies, the net present value of cash flows was computed along a single path of house prices and interest rates. This year, model estimates reflect a wide variety of possible economic conditions

The outcome of the complete actuarial study is the estimated "economic net worth" of the MMI Fund, which is defined by the National Housing Act as capital resources plus the present value of future cash flows of the MMI Fund. The calculation of economic net worth is repeated for each of the next seven years by adding projected endorsements each year, forecasting their cash flows and

² There are two additional sets of accounts that are independent of the insurance operations, and for which funds are directly appropriated by the Congress each year. The first is the set of Program Accounts which cover all personnel and administrative expenses for FHA operations. The other is the Liquidating Account, which represents remaining cash flows each year on pre-1992 insurance endorsements. The year 1992 marks implementation of the Federal Credit Reform Act of 1990 and introduction of the Financing Accounts.

adding them to those of the current portfolio, and then reassessing economic net worth on the updated portfolio at the end of each fiscal year.

Economic net worth represents additional resources directly available to FHA for absorbing costs above-and-beyond lifetime expected costs, or if negative, the additional resources necessary to cover lifetime costs on outstanding guarantees. Those calculations are for the remaining life of all outstanding loan guarantees and can extend for more than 30 years on HECM loans. Economic net worth is the numerator of the statutory capital ratio measure. The denominator is the outstanding dollar volume of active insurance contracts.

The credit subsidy re-estimate is performed each year as part of the federal budget process in accordance with the budget valuation of all federal direct loan and guarantee programs. For FHA single-family programs, this evaluation uses a modified version of the actuarial study forecasting model, applying the economic assumptions common to the President's Budget. The estimate is used to determine any necessary transfers between the MMI Fund Financing and Capital Reserve accounts, based on projections of expected claim expenses, premium revenue, and recoveries on outstanding loan cohorts over their remaining lifetimes (up to 30 years). If resources in the MMI Fund Financing and Capital Reserve accounts fall short of expected lifetime costs to the Fund, FHA would draw on support from the Treasury as explained above. Permanent and indefinite authority from Treasury is only necessary if FHA is unable to satisfy the budget re-estimate requirements from the funds in the Capital Reserve at the end of the fiscal year.

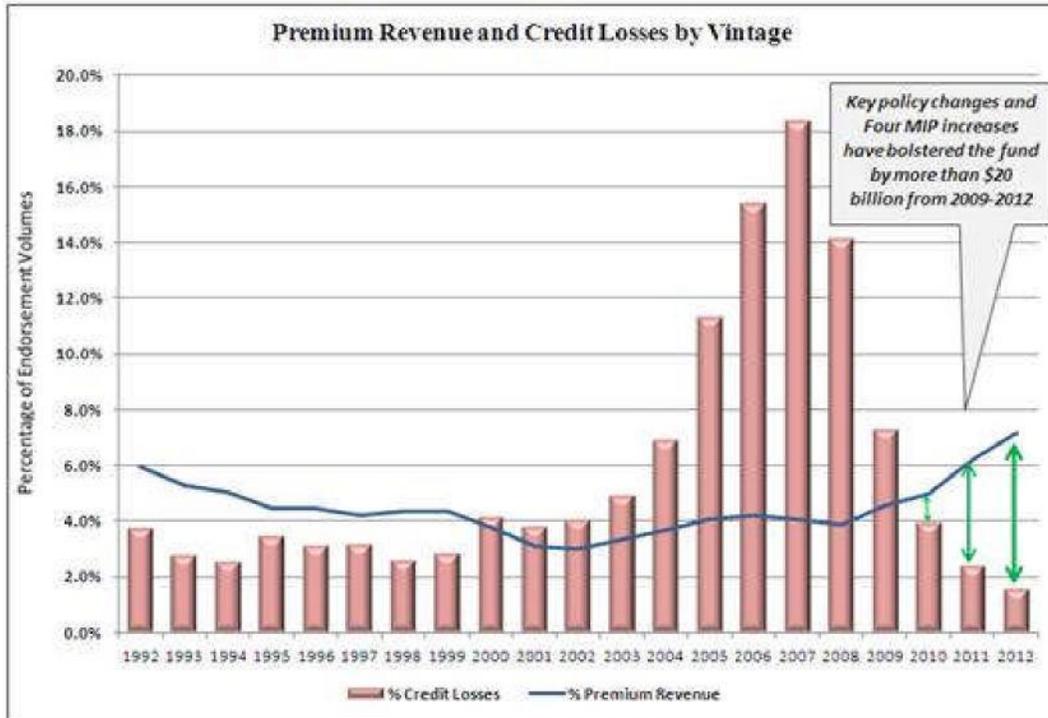
C. The FY 2012 Actuarial Review

In FY 2012, as noted above, the MMI Fund capital reserve ratio as calculated in the Actuarial Review fell below zero to negative 1.44 percent. The actuarial assessments estimate that the economic value of the Fund as of the end of FY 2012 is negative \$16.3 billion against an active portfolio of \$1.13 trillion. The economic value of the forward portfolio was estimated at negative \$13.5 billion, the HECM portfolio at negative \$2.8 billion. These economic values represent capital reserve ratios of negative 1.28 percent and negative 3.58 percent respectively. 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. Policy changes that were announced when the actuarial report was released are expected to accelerate the time to the Fund's recovery.

The low capital ratio today reflects an expectation that FHA's current pool of insured loans still has significant foreclosure and claim activity yet to occur. As stated previously, projected losses are particularly large for the fiscal year 2007-2009 loans, totaling \$70 billion in claims for these books alone.

Loans using seller-funded down payment assistance have proven to place substantial stress on the Fund. Those loans are projected to cost the Fund \$15 billion as they continue to experience elevated rates of insurance claim. In fact, the Actuary estimates that, if FHA had not insured any seller-funded-downpayment loans, the net economic value of the MMI Fund would be positive \$1.77 billion today. Thus, we are very grateful for the action by Congress in 2008 to eliminate seller-funded down payment loans from the FHA program, avoiding substantial additional losses from these loans.

In contrast to the drain caused by those older loans, the actuary expects endorsements in fiscal years 2010 through 2012 to produce significant net revenues that can be used to partially offset losses from earlier books of business. The contrast in quality between these two vintage eras—pre and post-2009—is based, at least in part, on the impact of key policy changes which have added over \$20 billion to the Fund since 2009—as demonstrated by the following chart.



Source: FY 2012 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

While the general trends revealed in the 2012 actuarial report are consistent with those reported in the reports of the past few years – books of business insured through 2009 are placing a great amount of stress on the MMI Fund while those insured since 2010 are adding substantial value to the Fund -- the overall results in the 2012 actuarial report differ substantially from the expected status of the Fund as projected in the 2011 actuarial report. There are three factors driving the change in the estimated economic value of the MMI Fund compared to what was projected in 2011:

- First, the house price appreciation forecast used in the 2012 actuarial study, predicted significantly lower levels of appreciation in the near term than the projections built into the forecast underlying the 2011 actuarial study. This yielded a cumulative difference in projected house price appreciation of 8 percentage points over the first five years. Thus, the downward revision in house price forecasts from 2011 to 2012 accounted for an estimated \$10.5 billion in reduced economic value compared to the actuary’s 2011 and 2012 projections of what the Fund’s economic value would be as of the end of FY 2012. Further, near-term house-price movements in the index used by the actuaries were depressed by high levels of refinance activity in 2012, and therefore, they do not reflect improvements seen this year to home prices

in other measures of housing market strength. Additionally, because the forecast utilized only covers the period through June 2012, it does not include substantial improvements to home prices seen since that time. Second, the continued decline in interest rates since last year, while good for the overall economy, causes a substantial loss of revenue. The reasons for this are two-fold. First, because of the higher interest rates being paid by borrowers on loans made before 2009, the actuary projects that these borrowers will default at marginally higher rates than would otherwise be expected.

- Second, the actuary projects that FHA loans would be paid off earlier than expected through refinances that take advantage of the lower rates—leading to lower premium revenue, and because the methodology required by statute that the actuary utilizes assumes that none of these loans will refinance back into FHA. The effect of the house price assumptions and low interest rates is a reduction of \$8 billion in estimated economic value for the Fund from what was anticipated in last year's report.
- Third, based on recommendations made by the GAO, HUD's Inspector General, at FHA's direction \$13 billion in reduced economic value is attributable to refined methods to better capture shares of Pre-foreclosure sale (PFS or short sales) and REO in claim predictions. Also, model structure changes removed an artificial cap on the effect of declining home prices on REO loss rates.

It should be noted that while the shift in value from what was projected last year to what was calculated in this year's review is substantial, the 2011 actuarial report did indicate that should house price appreciation or interest rates deviate from the base case scenario used for the actuary's projections, such deviations would impact the Fund's value in FY 2012. Furthermore, the FY 2011 report stated explicitly that there was an approximately 50 percent chance that if economic forecasts in FY 2012 differed materially from those used in the prior year's report, the Fund would have a negative value. These findings were the result of stress testing requested by HUD. While stress tests are not required by statute, FHA directs the actuary to perform them annually to provide greater insight into what may be expected if conditions deviate from those established in the base case scenario. For the FY 2012 report, FHA asked the Actuary to estimate the value of the Fund based upon those economic paths that yield the 10th best, 25th best, 25th worst, 10th worst and the singular worst projected economic values. Additionally, the Actuary was also asked to evaluate two additional scenarios which represent singular, deterministic economic paths with no random fluctuations. First was the Moody's Protracted Slump Scenario, the most stressful alternative scenario forecasted by Moody's Analytics in July 2012. Second was a Low Interest Rate Scenario, representing a continuation of the historically low interest rate environment prevailing at the end of FY 2012.

The significant shift in dollar value this year from what was expected in last year's report highlights the volatility associated with thirty year projections of economic conditions. Additionally, they are indicative of what occurs when underlying factors change for a portfolio the size of FHA's. The \$23 billion difference between the estimated value of the Fund in this year's actuarial review versus that projected in last year's represents only a 2 percent shift in value.

D. Actions Taken to Date to Protect the Fund

Throughout the tenure of this Administration, FHA has taken aggressive and decisive actions to improve the health and trajectory of the MMI Fund, while ensuring continued access to mortgage credit for American families. The changes made to FHA policy since 2009 are projected to have improved the economic value of the Fund by at least \$20 billion. That FHA's capital ratio has

remained positive until this year is primarily due to the reforms to risk management, credit policy, lender enforcement, and consumer protections made over the past four years – the most sweeping changes to policy in FHA’s nearly 80 year history. Our efforts to date to strengthen FHA have been focused on eliminating unnecessary risks and ensuring sufficient revenue generation from new endorsements while continuing to learn from what is working in our efforts to improve FHA’s asset management and loss mitigation approaches. As Secretary Donovan said before the Senate Banking Committee in December, that work is not over. To that end, in January and February of 2013, we issued additional guidance implementing policy changes to benefit the Fund.

1. Counterparty Risk Management and Lender Enforcement

One of the first things this Administration did upon taking office was to take strong actions to improve FHA’s monitoring and oversight of lenders. This has included substantial improvements to risk analysis systems and procedures, and policy changes to focus resources on the areas of FHA’s business which pose the greatest potential risk to the MMI Fund. These efforts have resulted in record numbers of lenders being withdrawn from FHA programs, substantial improvements in lender compliance with FHA requirements, and a number of settlements with lenders and servicers for violations of FHA origination or servicing requirements.

Additionally, we have been concerned of late with a number of web-based and print advertisements that proclaim the supposed ease of obtaining an FHA-insured loan following a foreclosure. While FHA has taken a number of proactive steps in the past few years to clarify its requirements regarding lender advertising and to enforce those requirements aggressively, we determined in recent months that it was necessary to address the issue of post-foreclosure advertising specifically. Therefore, on January 25, 2013 FHA issued a reminder to its industry partners that advertisements that imply that little or no qualification criteria are necessary to obtain an FHA loan are unacceptable and that FHA will not hesitate to take action within its authority to enforce its requirements related to lender advertising, including sanctions by HUD’s Mortgagee Review Board and/or referral to the HUD Inspector General or the Consumer Financial Protection Bureau (CFPB).

2. Credit Policy

We have also worked to strengthen our credit policies for FHA borrowers. First and foremost, FHA implemented Congress’s elimination of seller-funded down payment assistance programs which cost the MMI Fund more than \$15 billion in economic value. Further, we enacted increased down payment requirements for borrowers with credit scores below 580. The long-term positive impact of these two credit policy changes cannot be overstated. The 2005 – 2008 vintages, accounting for less than 15% of total originations over the last 30 years, are projected by the Actuary to contribute more than one-third of total credit losses of the Fund. Loans with credit scores below 580 and/or seller-funded down payment assistance will have accounted for 44% of those losses. Additionally, we have proposed regulations to reduce the amount of allowable seller concessions that increase risks to FHA arising from inflated appraisals.

In late 2012, FHA announced several additional policy changes that continue its work to strengthen credit policy while balancing the need to avoid negatively impacting the ongoing recovery and maintaining access to mortgage financing for credit worthy borrowers while also taking steps to recede FHA’s total market share. These steps – requiring manual underwriting

for borrowers with credit scores below 620 and debt to income (DTI) ratios over 43 percent, enhancements to FHA's TOTAL Scorecard, and a proposed increase in the required down payment for borrowers seeking loans in excess of \$625,500 – will, together with all the other measures outlined above as well as those detailed in Appendix A of FHA's Annual Report to Congress, will better ensure that home buyers using FHA-insured financing are capable of meeting their mortgage obligations and won't put undue stress on the Fund.

3. Increased Revenue

In addition to the improvements made to the quality of new endorsements, we have also made the difficult choice to increase mortgage insurance premiums for FHA-insured loans multiple times in the past four years. Since 2009, FHA has increased premiums five times – the most recent increase coming in response to the FY 2012 actuarial review, and which will add an additional \$150 or more in annual mortgage premium costs for the average FHA borrower. Combined, the premium increases made since 2009 have, to date, yielded more than \$10 billion in additional economic value for the Fund. These increases have not been undertaken lightly, and FHA has been careful to balance changes to pricing to improve the outlook of the Fund with its countercyclical role of providing liquidity and access to credit in the midst of the recent crisis and ongoing recovery.

4. Loss Mitigation and Asset Management

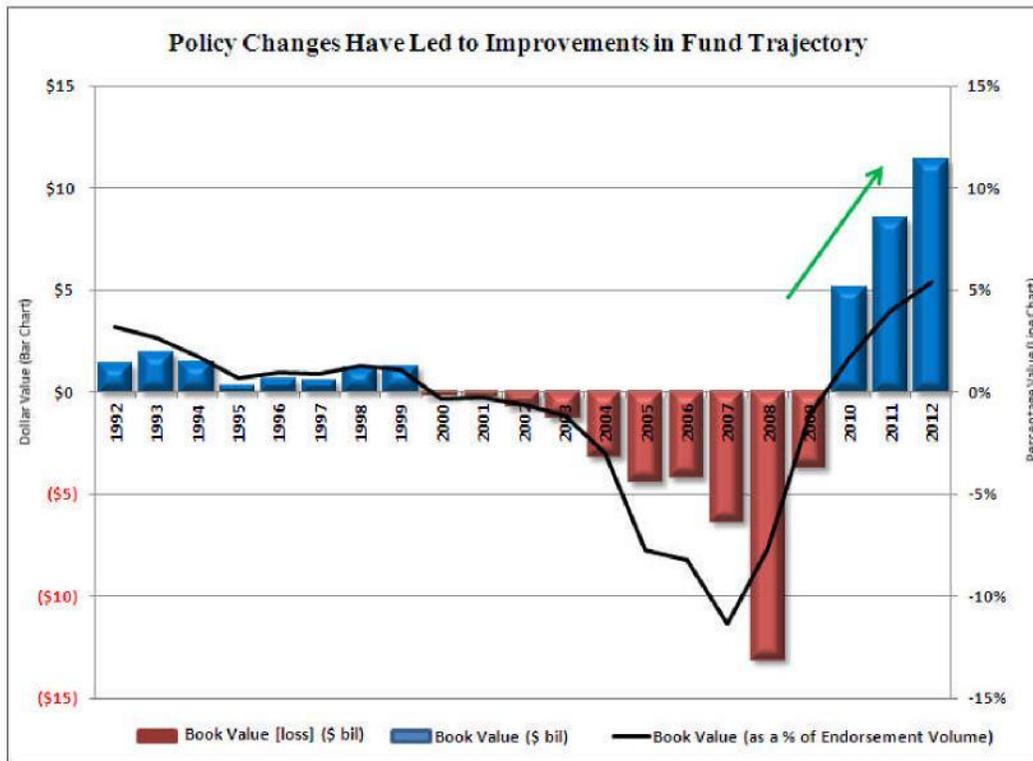
FHA has not just addressed issues associated with the origination of new loans, but has also taken decisive steps to control costs and limit losses on the back end of its business through improvements to its REO disposition processes and loss mitigation strategies. First, we changed our strategy and approach with regard to the REO management and marketing contracts through which FHA's REO property inventory is managed and sold. Enhancements to the oversight of contractors and better monitoring of their compliance with FHA guidelines, as well as measures which promote competition and continuity within specific markets, have resulted in notable improvements to FHA's REO processes. As a result of the changes HUD has made, the gap between appraised values of REO properties and their sales prices has decreased by 62% and the time in inventory for FHA properties has reduced by 45%, decreasing losses on the REO portfolio and improving recoveries for the Fund.

Finally, in FY 2012, FHA implemented a significant expansion of its note sales program whereby non-performing loans are sold in pools at a market-determined price via auction to investors, who are then able to explore options for homeowners to either remain in their homes or obtain a viable non-retention solution. This initiative, known as the Distressed Asset Stabilization Program (DASP), exponentially expands the number of loans sold in each sale while introducing innovations designed to promote stability in hard hit geographies. In addition to the sale of pools comprised of properties located throughout the nation, FHA also created Neighborhood Stabilization Pools of loans concentrated in specific Metropolitan Statistical Areas (MSAs). For the first sale in this expanded program, the MSAs of Newark, Tampa, Chicago and Phoenix were selected for inclusion in the program. These pools included additional requirements targeted at reducing the inventory of vacant foreclosed properties in these communities and providing enhanced options for homeowners and community members to benefit from these properties that would otherwise end up in FHA's REO inventory. The initial results from the first DASP sale were positive, resulting in the Actuary's estimate of improved economic value for the Fund from

this initiative of more than \$1 billion over the next two years. The next DASP sale is scheduled for March 2013.

The effectiveness of these changes can be seen in the stark contrast between books of business insured prior to 2010 and those insured since that time, which is clear in the graph below.

Economic Net Worth by Book-of-Business



Source: FY 2012 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

B. Additional Actions to Be Taken in FY 2013

While FHA has enacted substantial reforms under the current Administration, this year’s actuarial review makes clear that loans made prior to and at the outset of the recent crisis continue to weigh heavily on the health of the MMI Fund. Therefore, building upon the significant efforts already undertaken to protect and preserve the MMI Fund, FHA is implementing a series of additional actions to continue improving the Fund’s trajectory over both the short and long term. Using the Actuary’s model, collectively, these changes are projected to provide billions of economic value for the MMI Fund in FY 2013.

1. Reduce Losses from Legacy Books of Business

The changes made since 2009 to FHA’s lender oversight, credit policies, and premium pricing have yielded substantial improvements in the quality of new loans endorsed by FHA. But significant opportunity remains to reduce the impact on the Fund of poorly performing legacy

loans severely impacted by the recession, and to provide greater assistance for distressed borrowers as they seek to recover and find meaningful assistance in dealing with their delinquent loans. With a majority of FHA's projected losses attributable to loans insured from 2007-2009, FHA will take several additional steps to maximize recovery in the areas of loss mitigation and asset management.

The Actuary projects nearly \$60 billion in claims costs for FHA from seriously delinquent loans that will go to claim by the end of FY 2014, largely arising from loans insured between 2007 and 2009. As a result, reducing the severity of losses derived from these loans will exert a demonstrable positive impact to Fund performance over the next few years. Throughout the past fiscal year, FHA has been executing on an overall asset management strategy aimed at ramping up REO alternatives. REO alternatives (primarily short sales) comprised about 15%-20% of total dispositions since 2010, yielding average loss severities about 20% lower than REO. In recent months, as noted, FHA also unveiled its Distressed Asset Stabilization Program (DASP), another REO alternative that improves Fund performance. These and other actions have had a measurable effect, as loss severities have already fallen by 9% in the last year. A reduction in loss severities will further improve fund performance..

□ **Re-design of FHA Modification Treatments to Better Assist Delinquent Homeowners** FHA issued a Mortgagee Letter on November 16, 2012 that established revised standards for repayment plans, standard modifications, and FHA-HAMP loss mitigation products, which are expected better assist distressed borrowers and reduce losses to the Fund from foreclosures. FHA loss mitigation policies will be geared towards greater payment relief for borrowers, targeting payment reductions of at least 20% for FHA-HAMP modifications, which will result in more sustainable payment outcomes for borrowers over the long term. This approach is intended to yield lower claim costs for FHA while also reducing prepayment speeds for insured loans, both of which will positively impact the MMI Fund.

□ **Streamlining of the FHA Short-sale Policy** Although FHA is deeply committed to providing loss mitigation alternatives to borrowers which permit them to retain their homes, home retention is simply not an option for some borrowers. For these borrowers, pre-foreclosure sales (short-sales) offer an opportunity to transition out of their homes. This enables both FHA and the borrowers to avoid the costs and damages of the foreclosure process. FHA will introduce a streamlined pre-foreclosure sale policy which removes certain barriers for borrowers in obtaining a short sale on their FHA-insured mortgage. This change is expected to increase the number of defaulted loans that end in short sales rather than foreclosures. Because losses from short-sales are substantially lower than from the traditional FHA REO process, the shift of greater numbers of distressed homeowners to short-sale dispositions rather than foreclosures are anticipated to yield better results for the MMI Fund while allowing distressed borrowers to start anew without having to go through the difficult and costly foreclosure process.

□ **Claim without Conveyance Pilot Program** FHA plans to expand a pilot whereby properties secured by non-performing FHA-insured loans are offered for sale by the lender who has completed the foreclosure process. At a reserve price slightly below the outstanding unpaid principal balance of the loan, the properties are sold to third party purchasers without ever being conveyed to FHA. This

method of disposing of these properties is expected to yield lower losses for the MMI Fund than selling them through FHA's normal REO disposition process, as carrying costs associated with preserving, managing, and marketing an REO property were eliminated.

Proactive Strategies to Further Improve Recoveries

In addition to the policy and programmatic changes outlined above, FHA will also take several innovative and proactive steps to increase utilization of loss mitigation options and reduce unnecessary asset disposition losses. First, beginning in 2013, FHA will launch a large-scale proactive marketing campaign to promote modification and short-sale strategies for delinquent borrowers. This effort is expected to increase utilization of these programs, which will permit more borrowers to become aware of and take advantage of these opportunities, while reducing foreclosures and decreasing associated losses for FHA. In addition, FHA will also pursue more creative strategies to dispose of REO properties in geographies where traditional asset disposition methods yield net negative recoveries for FHA. This approach is anticipated to both save money for FHA on unnecessary losses as well as contribute to community stabilization initiatives in cities hit hard by the recession.

2. Further Strengthen the Quality and Impact of New Endorsements

While much has been done under the current Administration to improve the performance and revenue of new FHA endorsements, we believe it is vital to take additional steps to strengthen new books to ensure the long term health of the MMI Fund. Accordingly, in the second quarter of FY 2013, FHA will implement the following policies for new originations.

Revised Premium Cancellation Policy

Under a policy change made in 2001, FHA has been cancelling required mortgage insurance premiums (MIPs) on loans for which the outstanding principal balance reaches less than 78% of the original principal balance. However, FHA remains responsible for insuring 100% of the unpaid principal balance of a loan for the entire life of the loan, such loan life often extending far beyond the cessation of MIP payments. As written, the timing of MIP cancellation is directly tied to the contract mortgage rate, not to the actual loan LTV. That policy, which was reversed in a Mortgagee Letter published on January 31, 2013, was put in place at a time when it was assumed that home price values would not decline, but today we know that LTV measured by appraised value in a declining market can mean that actual LTVs are far lower than amortized mortgage LTV, resulting in higher losses for FHA on defaulted loans. Analyses conducted by FHA's Office of Risk Management projects lost revenue of approximately \$10 billion in the 2010-2012 vintages as a result of the current cancellation policy. The same analyses also suggest that 10%-12% of all claims losses will occur after MIP cancellation. Therefore, beginning with new loans endorsed after June 6, 2013, FHA plans to once again collect premiums based upon the unpaid principal balance of FHA loans for the entire period during which they are insured, permitting FHA to retain significant revenue that is currently being forfeited prematurely.

MIP Increase

We are very grateful for the flexibility Congress granted us in 2010 to adjust FHA's premium pricing. And we have utilized that flexibility five times, with the most recent increase in annual MIP released in a mortgagee letter on January 31, 2013. Consistent with FHA's continued efforts to balance its countercyclical role in the nation's mortgage market with its

responsibility to manage the Fund, FHA will increase annual mortgage insurance premiums by an additional 10 basis points. While the new loans being made today are profitable to FHA and we do not want to over-burden or constrict access to credit as the housing market continues to mend, we also must ensure that we are 1) rebuilding adequate reserves for the future and 2) phasing out of our counter-cyclical role by reducing FHA's footprint in the marketplace and helping to facilitate the return of private capital. FHA has played a vital part in ensuring access to credit for borrowers and liquidity in the market, yet its current outsized role should and will decrease. Indeed, its market share has declined yearly since a peak in 2009. This premium increase, \$13 per month for the average FHA borrower, which FHA plans to implement in 2013 will add significant revenue to the Fund and ensure that FHA does not take on additional market share, while at the same time being modest enough that it doesn't impact borrower access to credit or threaten our emerging housing recovery.

□ Future Credit Policy and Pricing Changes

While much has already been done to improve the quality of new FHA endorsements, the effectiveness of which are clear in the performance and projected value of loan cohorts insured since 2010, FHA is continually evaluating its portfolio to identify and mitigate risks, and to provide enhancements that benefit both consumers and the Fund. And we welcome additional proposals which will further assist in strengthening the MMI Fund.

□ Housing Counseling Incentive Policy

Significant evidence has shown that housing counseling improves the success of home buyers – particularly first time homebuyers.³ FHA intends to develop new policies which incentivize, or in some cases require, borrowers to complete a pre-purchase housing counseling program prior to the purchase of a home using FHA-insured financing. We will work during this fiscal year to craft and receive feedback on the precise contours of this initiative. This endeavor is expected to ultimately improve outcomes for both borrowers and FHA, reducing losses to the Fund as higher numbers of new borrowers attain successful home purchases.

3. Stabilize and Strengthen the HECM Program

Changes in borrower utilization of the HECM program and the modeling changes employed by the actuary for the FY 2012 review show substantial stress in the HECM program. In order to mitigate the negative impact of the 2013 and future HECM books on the MMI Fund, FHA is taking aggressive actions in both the near and long terms to ensure that consumers are better protected and able to sustain their reverse mortgage, while also protecting the Fund.

□ Immediate Steps to Reduce Losses in the Near Term

Given current regulatory authority, FHA has limited ability to address root cause issues and will, therefore, be forced to make blunt changes to the program on an interim basis. FHA

³ HUD conducted a review of pre-purchase counseling that was published in 2012, which also found that the program was serving its intended population. The study tracked 573 participants at 12 to 18 months after receiving pre-purchase counseling services. Only one of the purchasers had fallen at least 30 days behind on his or her mortgage payments and none had a major derogatory event on a mortgage account. A report on the study's findings can be found at:

http://www.huduser.org/portal/publications/hsgfin/pre_purchase_counseling.html

will take immediate action to better align the program with its objective of enabling seniors to age-in-place. These changes will protect FHA from losses and reduce the likelihood of borrower defaults due to nonpayment of property taxes and insurance.

In administrative guidance dated January 30, 2013, FHA consolidated the Fixed Rate Standard program with the Fixed Rate HECM Saver product, which will result in a reduction of the maximum amount of funds available to a HECM borrower.

Additionally, in an effort to reduce losses associated with the conveyance and disposition of properties mortgaged with a HECM, FHA will issue new incentives for estate executors of HECM borrowers to dispose of properties themselves rather than conveying them to HUD. Executors are permitted to either sell such properties or convey them to HUD. Reversing the historical trend, over the past few years, larger numbers of executors have been choosing to convey these properties to FHA rather than sell them, adding costs and reducing recoveries for FHA. By incentivizing the sale of properties by executors, FHA is able to avoid property management, maintenance, and marketing costs associated with the REO disposition process, thereby reducing losses to the Fund on these properties.

□ Longer-term Changes to Permanently Strengthen the Program

Over a longer term, either through the granting of the legislative authority described below or via the much longer rule making process, FHA will also pursue other material changes to ensure the long-term viability of the HECM program. These measures include:

- Limiting the draw at origination to mandatory obligations (i.e. closing costs, mortgage liens and federal debt), providing greater flexibility in addressing the individual needs of borrowers than the across-the-board reductions to principal limit factors described above, while still protecting the Fund from losses on loans where the maximum loan amount is drawn up-front;
- Performing a financial assessment of borrowers as a basis for loan approval and determining the suitability of various HECM products to protect consumers from acquiring loans not fit for their situation; and
- Establishing a tax and insurance set-aside to ensure sufficient equity or an annuity is available to pay taxes and insurance on the mortgaged property so that defaults resulting from nonpayment of taxes and insurance can be avoided.

E. Legislative Requests to Further Strengthen the Fund

Over the past several years, Congress has moved in important ways to strengthen and protect FHA, and for that we are very grateful. Indeed, were it not for the flexibility granted by Congress to FHA in 2010 in setting premium pricing, the current economic value of the MMI Fund would be more than \$10 billion lower than it is today. And the work this body has done to establish FHA's first ever Office of Risk Management has been instrumental to our improved ability to identify risks in FHA programs and take action to mitigate them. So thank you for your commitment to making FHA stronger and more secure over the long term.

But today, we are asking for your help once again so that FHA is better able to protect the Fund while continuing to execute its mission. The proposals outlined below will enhance FHA's ability to hold lenders accountable for non-compliance with FHA policy and provide greater flexibility for FHA

to make changes to policies and procedures as emerging needs and trends are identified. As a result, FHA will better be able to avoid unnecessary losses before they occur.

1. Indemnification Authority for Direct Endorsement Lenders: This provision, which FHA has been seeking since 2010, would allow FHA to seek indemnification from Direct Endorsement lenders, which represent 70% of all FHA approved lenders. Currently FHA only has authority to require indemnification for lenders with Lender Insurance (LI) approval. In granting this authority, FHA will be able to obtain indemnification from all of its approved lenders for loans that do not comply with its guidelines.

2. Revised Indemnification Authority: This change would eliminate the “knew or should have known” standard with regard to fraud or misrepresentation. While the Government-Sponsored Enterprises require lenders to retain all fraud related risk, FHA only holds lenders accountable for fraudulent activity if they “knew or should have known” of its occurrence. Providing proof to meet this standard limits FHA’s ability to require lenders to be accountable for fraud in FHA-insured loans, and its removal would significantly improve FHA’s ability to avoid unnecessary losses arising from fraudulent activity.

3. Authority to Terminate Origination and Underwriting Approval: This legislation would give FHA enhanced ability to review lender performance and, if a lender is found to have an excessive rate of early defaults or claims, would provide greater flexibility in terminating the approval of the lender to originate or underwrite single family mortgages for FHA insurance. FHA has been seeking this authority since 2010.

4. Revised Compare Ratio Requirement: This provision would revise the statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance so that it more effectively captures the true performance of a lender during all market conditions, minimizing further poor performance by FHA lenders while reducing uncertainty for them. Specifically, this legislation would allow the Secretary to compare the rate of early defaults and claims for insured single family mortgage loans originated or underwritten by a lender with those same rates for other lenders on any basis the Secretary determines appropriate, such as geographic area, varying underwriting standards, or populations served. Further, the provision would permit the Secretary to implement such comparisons via regulations, notice, or Mortgagee Letter. This will allow FHA to tailor the compare ratio such that it provides meaningful comparisons of lenders in varying market conditions, providing greater clarity for lenders and a more refined understanding of their performance for FHA.

5. Authority to Transfer Servicing: In order to facilitate more effective loss mitigation, this change would give FHA the authority to require poorly performing servicers to transfer individual loans to another servicer with better performance results. Such authority would permit FHA to better avoid losses arising from poor servicing of FHA-insured loans, yielding better results for both borrowers and FHA.

V. Conclusion

Mr. Chairman, there are real signs of recovery in the nation’s housing market. Given the progress we’ve seen—and FHA’s central role in that progress—it’s clear that FHA has done precisely what it was

designed to do. It has allowed millions of American families to benefit from homeownership and affordable rental options. It has provided vital liquidity in the nation's mortgage finance markets. And it has acted as a vital stabilizing force when an economic crisis precipitated by the housing market could have led to a second Great Depression. FHA must continue to be a reliable steward of taxpayer dollars and also remain a key source of access to homeownership for the families of today and for future generations. We are committed to that goal, and we look forward to collaborating with Members of this committee in that effort.