

# Center for American Progress



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**The Future of Housing in America: Oversight of the Federal Housing Administration, Part II**  
**Testimony before the U.S. House of Representatives Committee on Financial Services**  
**Subcommittee on Housing and Insurance**

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Good morning Chairman Luetkemeyer, Ranking Member Cleaver, and members of the subcommittee. My name is Julia Gordon, and I direct the housing and consumer finance team at the Center for American Progress, a nonpartisan think tank dedicated to improving the lives of Americans through progressive ideas and action. Thank you so much for convening this hearing on the Federal Housing Administration, or FHA. I greatly appreciate the opportunity to testify today about the FHA and its importance to America's families, the housing recovery, and the broader economy.

## **Introduction**

Research and our lived experience confirm the link between housing and opportunity in this country, from the many benefits of homeownership for families and communities to the central role of the housing economy on economic vitality. A healthy housing market, when coupled with appropriate protections to ensure responsible and sustainable lending, offers opportunities for young people to begin building wealth through homeownership, for growing families to access good schools and high-opportunity neighborhoods, and for older people to choose whether to age in place or seek a smaller or more supportive environment.

Yet at present, the nation's housing recovery is neither strong nor equitably distributed. Not only has the national mortgage market shrunk significantly, but many communities, especially communities of color, lag far behind non-Hispanic white communities, and hard-hit neighborhoods continue to suffer the ongoing effects of multiple foreclosures, negative equity, vacant homes, and blight. We have turned back the clock nearly 20 years on homeownership rates, and rental costs are soaring relative to incomes.<sup>1</sup>

Consequently, the Federal Housing Administration is now more important to the country than ever. Established in 1934 to promote long-term stability in the U.S. housing market after the

foreclosure crisis that occurred during the Great Depression, FHA reinvented housing finance by demonstrating that long-term, fixed-rate mortgages could help middle-class families build long-term economic security even through uncertain economic times and that lenders could extend credit to a broad population on fair terms with good economic results.<sup>2</sup> In the 80 years since, FHA has helped more than 40 million creditworthy families realize the benefits of homeownership.<sup>3</sup>

Since that time, FHA's role has evolved. First, the agency focuses on facilitating homeownership for creditworthy borrowers who would otherwise have difficulty putting together a 20 percent down payment, such as first-time homebuyers and homebuyers of color. To accomplish this goal, FHA doesn't lend directly to homebuyers. Rather, it insures loans made by private lenders that meet strict size guidelines and underwriting standards. To fund this insurance, the agency charges both upfront and annual fees, the cost of which the borrowers cover themselves.

Second, FHA keeps mortgage credit flowing during business cycle downturns when private investors retreat. This so-called countercyclical role proved to be of critical importance in preventing a much more severe collapse of the housing market after the 2008 financial crisis. While playing this role severely strained the agency's finances, a combination of strong management, critical policy changes, and overall improvement in the housing market—in part due to FHA lending—has put the agency on track to fully replenish its capital reserve fund within the next two years.

Going forward, FHA should continue to assisting first-time and low-wealth borrowers, provide stability in the mortgage market, and maintain the insurance fund's financial integrity. While Congress should provide necessary oversight to ensure FHA is pursuing this mission in a responsible fashion, FHA needs the authority and latitude to make certain business judgments within the congressionally mandated framework.

In this testimony, I will discuss the work of today's FHA, the state of FHA's finances, and several improvements that FHA can make to further its mission of supporting homeownership while strengthening its financial position.

## **I. FHA Today: Providing America's families with safe and sustainable loans and supporting the housing market through the business cycle**

FHA's most recent books of business will likely perform better than any books of business in the agency's history, yet FHA's critics continue to insist that FHA engages in risky, predatory lending. A review of the agency's policies and processes demonstrates that today's FHA supports loans are safe, sustainable, and appropriate for the communities they serve.

## **A. Providing America's families with safe and sustainable loans**

Even in the run-up to the crisis, FHA *never* insured the type of dangerous, poorly underwritten loans that triggered the financial crisis. The predatory loans securitized by Wall Street during the boom were hybrid adjustable rate mortgages, interest-only loans, and so-called “pick-a-pay” loans that featured extremely low teaser rates with steep resets, prepayment penalties that extended beyond the loan reset dates, and numerous other confusing features. The sudden increases in monthly payments required borrowers to refinance repeatedly, generating impressive fees for brokers but stripping borrower equity. Additionally, mortgage brokers got paid more to put borrowers in loans at higher rates than they qualified for, to lock borrowers into those loans with prepayment penalties, and to encourage borrowers to choose products that required little or no income documentation.<sup>4</sup>

Contrast those toxic loans to FHA loans, the vast majority of which are “plain vanilla,” long-term, fixed-rate mortgages with no resets and no prepayment penalties; unlike most private mortgages, most FHA mortgages are even assumable. The agency has always required full underwriting and documentation: a key reason that FHA lost so much market share to private label securitization was that brokers and real estate agents wanted to avoid the paperwork involved in processing an FHA loan.<sup>5</sup>

That is not to say that FHA has never engaged in discriminatory and risky practices. Early in its history, FHA engaged in “redlining,” which meant refusing to insure loans made in communities of color, which denied African Americans and other minorities the opportunity to build the wealth that helped so many white families enter America's growing middle class after World War II.<sup>6</sup> The Fair Housing Act of 1968 prohibited this practice, and after continued struggles with discriminatory pricing and fraud, including shoddy underwriting and inflated appraisals,<sup>7</sup> FHA has now become not just a reliable source of credit for communities of color, but in many ways, the only reliable source.

Another risky practice was instituted during the housing boom, when FHA offered a program of seller-funded down payment assistance in which nonprofit groups funded primarily by home builders provided borrowers with down payment assistance. Unfortunately, the incentives in this program were not properly aligned, leading some builders to inflate the prices on these loans, which resulted in many borrowers being underwater on their mortgages from day one. This program performed extremely poorly during the crisis; in fact, it contributed so heavily to FHA losses that had these loans not been made, FHA would have nearly reached its 2 percent capital ratio by now.<sup>8</sup> For years, FHA wanted to end the seller-funded down payment assistance program, but Congress prevented them from doing so until 2008, and the change did not take effect until the second fiscal quarter of 2009.

Another excessively risky program was the FHA reverse mortgage program, enabled by a change to the law signed by President Ronald Reagan in 1987.<sup>9</sup> This program offered a product that was potentially helpful for some seniors, but it carried far too few consumer protections

for something so confusing and potentially damaging, and seniors using the program became a target for those selling fraudulent or inappropriate financial products.

However, since 2008, FHA has eliminated the seller-funded down payment program, significantly overhauled the reverse mortgage program, and instituted numerous other changes to protect taxpayers, strengthen FHA's risk management, and ensure borrowers are put into high-quality mortgages in which they will succeed.

Most importantly, to protect consumers and reduce risk-layering, FHA now specifies a minimum credit score, requires a much higher down payment for borrowers with credit scores below 580, and requires manual underwriting for any borrower with a credit score under 620 and a debt-to-income ratio of more than 43 percent, a practice that results in safer loans because borrowers must demonstrate compensating factors.

Contrary to some statements made in this committee recently,<sup>10</sup> FHA loans all must conform to the Dodd-Frank Act's mortgage rules that require lenders to assess a borrower's ability to repay before making a mortgage. Dodd-Frank also required FHA to develop its own qualified mortgage, or QM, standard, which is very similar to the standard established by the Consumer Financial Protection Bureau for the private market, and the agency finalized that standard in December 2013.<sup>11</sup> Loans made under all of these policies will have an extremely high chance of success.

Also, to rebuild the fund and to align risk with pricing, FHA has increased its annual mortgage insurance premium significantly; even after the recent decrease announced in January by President Barack Obama, the annual fee is still 50 percent more than it was in 2008.<sup>12</sup> It has also raised its upfront insurance fee by 75 percent and required that premiums be paid for the life of their loan rather than being cancellable when the loan reaches a 78 percent loan-to-value ratio.<sup>13</sup>

Other important changes include the following:

- FHA has improved its loss mitigation processes, which simultaneously provide troubled borrowers with expanded opportunities to avoid foreclosure and also result in lower losses for the fund.
- FHA has also increased the number of individual pre-foreclosure sales—or short sales—and is selling thousands more properties pre-foreclosure through bulk auctions, a program known as the Distressed Asset Stabilization Program, or DASP. Selling loans before foreclosure allows FHA to avoid taking possession of the property, saving significant money on maintenance and marketing costs for houses that it took possession of after foreclosure. FHA estimates that the DASP alone has reduced losses by an estimated \$3 billion over the past two years.<sup>14</sup> These policy changes, alongside improving home prices, has meant that recoveries on insurance claims have increased 68 percent since their lowest level.<sup>15</sup>
- FHA is improving its Quality Assurance Taxonomy, which provides improved definitions of loan manufactured defects. This project aims to improve the quality of loans that FHA

insures while also providing lenders with more certainty about what loans FHA will force them to buy back due to their errors or fraud. FHA is also working to increase clarity for lenders by consolidating its disparate pieces of guidance into a single source.

- HUD has also heightened its enforcement of FHA lenders, terminating relationships with lenders who violate its requirements and generating millions of dollars in penalties from lenders who violate HUD rules.<sup>16</sup>
- FHA has made important changes to its reverse mortgage program, limiting both the upfront and overall equity that is available to borrowers, requiring that these lenders assess a borrower's ability to pay taxes, insurance, and other property expenses or escrow for these funds for the borrower, and requiring customers to obtain housing counseling before obtaining a reverse mortgage.
- FHA has created an Office of Risk Management, imposed higher minimum net-worth requirements for lenders to mitigate counterparty risk, and updated appraisal standards.

Despite its safe and sustainable loans and greatly improved business processes, critics continue to attack FHA's basic business model. Some critics simply oppose low down payment lending, mistakenly believing that low down payments were what led to the housing crisis. Yet properly underwritten, low down payment mortgages with long-term, fixed interest rates have performed well even throughout the Great Recession.<sup>17</sup> The predatory mortgages that brought down Wall Street's house of cards sometimes included low down payments, but they also layered multiple risks—such as exploding interest rates, exorbitant fees, and steep prepayment penalties—with little or no underwriting. Most of these practices are now prohibited by the Dodd-Frank mortgage rules.

Other critics portray FHA as a destabilizing force in communities, such as the December 2012 American Enterprise Institute report written by Ed Pinto titled "How the FHA Hurts Working-Class Families and Communities."<sup>18</sup> In this report, Pinto presents a correlation between FHA and high foreclosure rates in distressed communities as if to imply that the FHA is responsible for the high foreclosure rate. Yet the concentration of FHA loans and the high rates in these communities are largely a result of the unsustainable private subprime mortgages pushed in these communities during the housing bubble. FHA was one of the only lenders supporting the housing market in these distressed communities at the height of the foreclosure crisis because most private lenders had fled the credit risk of such neighborhoods; in other words, FHA's presence was not a cause but a consequence of the neighborhood's financial distress. Had FHA followed Pinto's ill-supported advice and refrained from lending in distressed neighborhoods, many of the neighborhoods that are now entering a recovery period likely would have been lost for good.

What's more, the report relies on data from the 2009–2010 book years, just months after the government bailed out the nation's major financial institutions, Fannie Mae and Freddie Mac entered conservatorship, credit markets froze, unemployment spiked, and housing prices were in free fall. Additionally, the 2009 book also still includes a sizable chunk of seller-financed down payment assistance loans.

That said, Pinto's report raises important questions that it will be worth continuing to discuss, especially how to encourage the conventional market to lend to qualified borrowers in underserved communities and populations to promote competition and avoid unnecessary concentration of FHA loans.

## **B. Supporting the housing market through the business cycle**

The past two decades have been a time of great volatility and challenge for FHA, and its performance over this period has proven its critical role in America's mortgage market.

Beginning in the 1990s, with the emergence of new mortgage products bundled by Wall Street investment firms into private mortgage-backed securities, the mortgage market underwent a historical shift. The new lending featured products with dangerous loan terms such as steep rate resets, prepayment penalties, and negative amortization, and underwriting ranged from poor to nonexistent.<sup>19</sup> Yet because teaser rates and other pricing gimmicks made these loans appear more attractive and because mortgage brokers needed to do less paperwork and were offered better compensation for pushing these loans,<sup>20</sup> many borrowers who would have qualified for prime conventional or FHA loans ended up in these dangerous subprime loans instead.<sup>21</sup>

As private subprime lending gained market share for low down payment borrowers during this period, FHA's market share plummeted. In 2001, the Federal Housing Administration insured 14 percent of home-purchase loans; by 2006, that number had decreased to less than 4 percent.<sup>22</sup> Some lenders expressed concern about FHA's very survival.<sup>23</sup>

When the bubble fueled by this unsustainable lending finally burst in a flood of delinquencies, defaults, and foreclosures, the housing market teetered on the edge of collapse. The Wall Street firms that had fueled the private label securitization stopped providing capital, banks and thrifts pulled back, and subprime and nontraditional lending essentially came to a halt. Fannie Mae and Freddie Mac were placed under conservatorship when their capital proved inadequate, and they both imposed new fees, including steep risk-based pricing that significantly limited the ability of the mortgage giants to serve any but the most pristine borrowers. Private mortgage insurer, or PMI, activity plummeted,<sup>24</sup> with some PMI companies failing and regulators taking over others.<sup>25</sup> For many lenders and borrowers, FHA was the only place to turn. (see Figures 1 and 2)

Figure 1:

### First Lien Origination Volume and Share

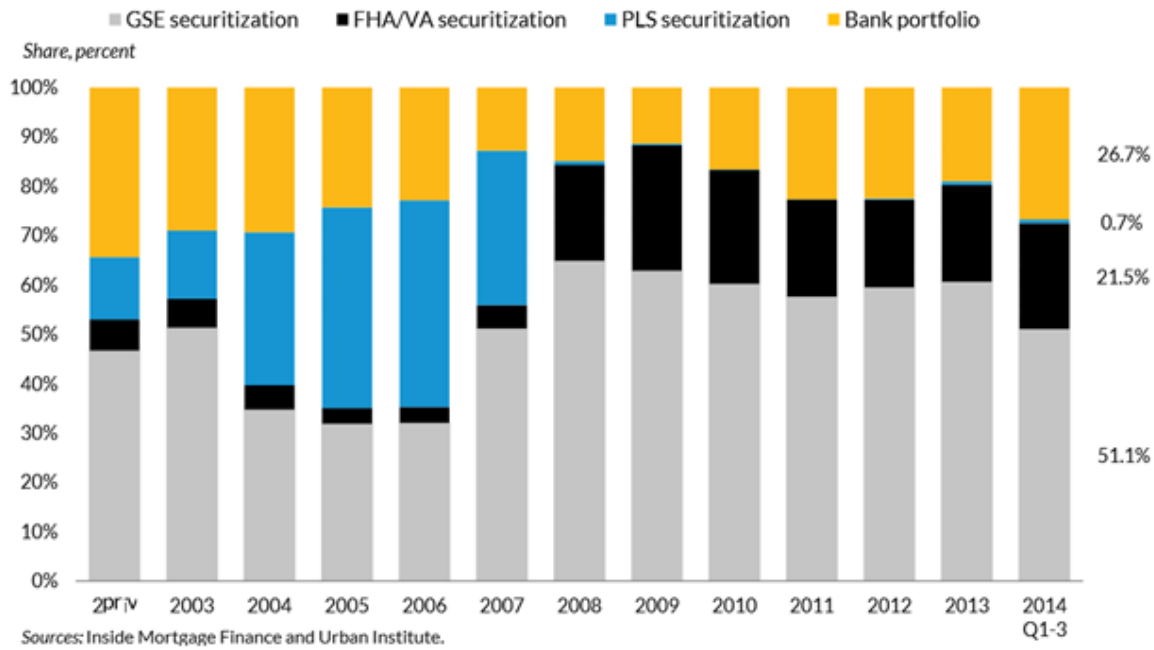
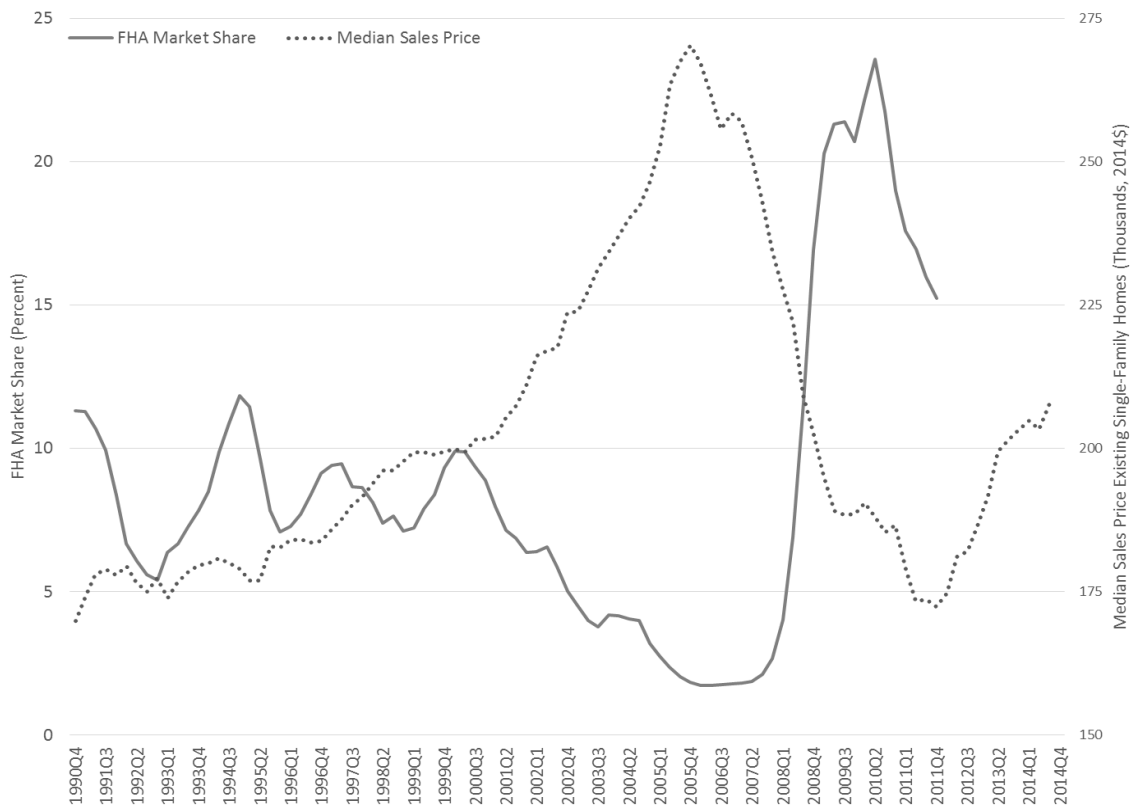


Figure 2: The Federal Housing Administration's countercyclical market share



Four-quarter moving market share. Source: Inside Mortgage Finance; National Association of Realtors®; Moody's Economy.com. Compiled by Kevin Park and Roberto Quercia at the UNC Center for Community Capital.

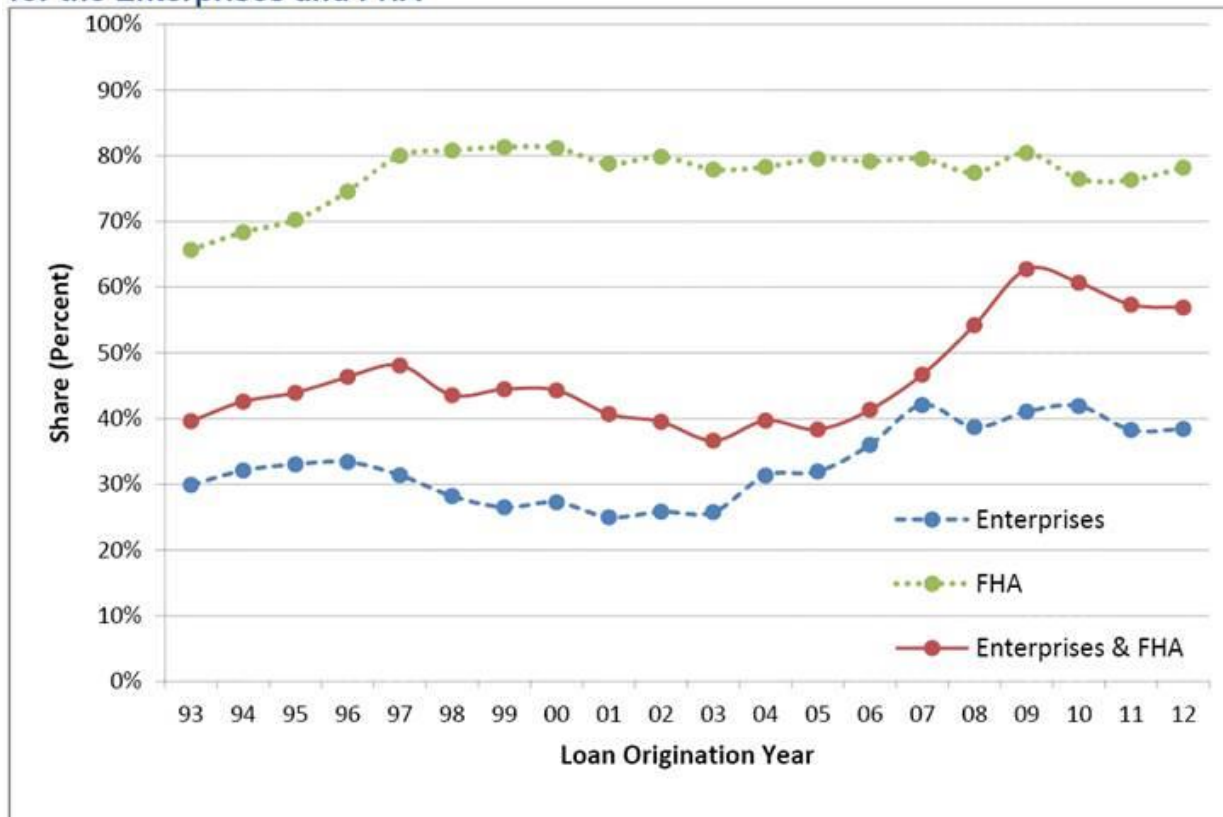
Moody's Analytics estimated that if FHA had not been available to fill this gap, mortgage interest rates would have more than doubled, new housing construction would have plunged by more than 60 percent; new and existing home sales would have dropped by more than one-third; and home prices would have fallen twice as far as they did.<sup>26</sup> The analysis suggests that a second collapse in the housing market could have sent the U.S. economy into a double-dip recession, causing the economy to shed another 3 million jobs and the unemployment rate to rise an additional 1.6 percent.<sup>27</sup> We can only imagine what this additional damage would have meant for losses and taxpayer costs at Fannie Mae and Freddie Mac, as well as other large financial institutions involved in the mortgage market.

Without FHA, the mortgage market would still be in far worse shape than it is. Since stepping into the breach in 2008, FHA has backed more than 5.5 million home-purchase loans and helped another 3.5 million families lower their monthly payments by refinancing.<sup>28</sup>

Equally important is the composition of FHA borrowers. In 2014, 81 percent of FHA endorsements in 2014 were for first-time homebuyers.<sup>29</sup> (see Figure 3)

**Figure 3:**

**Exhibit 3. First-Time Homebuyer Shares of Purchase-Money Loans for the Enterprises and FHA**



Source: FHFA loan-level data of purchase loans for primary residences from Fannie Mae, Freddie Mac and FHA.



Moreover, in 2014 more than three-quarters of FHA's endorsements<sup>30</sup> were for home-purchase loans, whereas only half of Fannie Mae and Freddie Mac originations were for home-purchase loans.<sup>31</sup> In 2013, although FHA only constituted about one-fifth of the overall market,<sup>32</sup> it backed *almost half* of the home-purchase mortgages obtained by African Americans and Latino homebuyers.<sup>33</sup>

Even as the economy recovers, first-time homebuyers and other lower-wealth households still cannot access conventional loans, yet their participation remains critical to the health of the mortgage market. Right now, for a conventional home-purchase mortgage, the average FICO score is 752, while for FHA, it is closer to 680—still much tighter than historical norms, but more accessible to the typical household (nationally, the median credit score is 711).<sup>34</sup> Additionally, homeownership rates for young people—ages 25 to 34—are among the lowest in decades<sup>35</sup> at a time when it is most important to have new households entering the market. The Bipartisan Policy Center estimates that Echo Boomers—those born between 1981 and 1995—will drive 75 percent to 80 percent of owner-occupied home acquisition before 2020 as Baby Boomers sell off their homes.<sup>36</sup> Homes are significant reservoirs of wealth for Boomer families, and their retirement security and ability to remain independent may be significantly affected if new households are unable to provide sufficient effective demand for these homes.

## II. Current financial condition: Recovering from its crisis role

Today, FHA's Mutual Mortgage Insurance Fund is back in the black, with a value of positive \$4.8 billion.<sup>37</sup> The current state of the fund reflects a \$21 billion dollar improvement over the past two years. While the agency has not yet rebuilt its capital cushion to the statutory 2 percent level, it is well on its way to doing so while continuing to balance its dual mission of supporting homeownership while maintaining the fund.

FHA's January 2015 announcement in January 2015 that it would reduce its annual premium deserves fuller explanation. Since the crisis, FHA has increased its premiums five times, including increasing both the upfront premium and the annual premium and disallowing the cancellation of the annual premium after the loan-to-value ratio hits 78 percent.<sup>38</sup> This recent reduction applies only to the amount of the annual premium and only partially rolls back the increases made since the crisis. The upfront premium remains unchanged and the annual premium is still in place for the life of the loan.

Even after the premium cut, the Office of Management and Budget, or OMB, projects that new loans in FY 2016 will make a net profit to taxpayers of 3.7 percent on an average FHA loan—and a gross profit to taxpayers of \$6.423 billion<sup>39</sup>—and both FHA actuaries and Moody's Analytics have found the premium reduction will not make a very significant difference in the time it takes FHA to reach the 2 percent mark.<sup>40</sup> In short, this is a modest, carefully calibrated action that strikes the proper balance between increasing access to credit and maintaining fiscal prudence.

Chairman Jeb Hensarling's claim that the U.S. Department of Housing and Urban Development, or HUD, is violating the law by reducing its annual premium at a time when the ratio has not yet returned to 2 percent<sup>41</sup> takes the required ratio out of the context of the entire statute. Specifically, when the insurance fund is undercapitalized, the HUD secretary may "propose and implement any adjustments to the insurance premiums" and must consider FHA's capital requirements alongside other "operational goals," including "meeting the needs of homebuyers with low down-payments and first-time homebuyers by providing access to mortgage credit."<sup>42</sup>

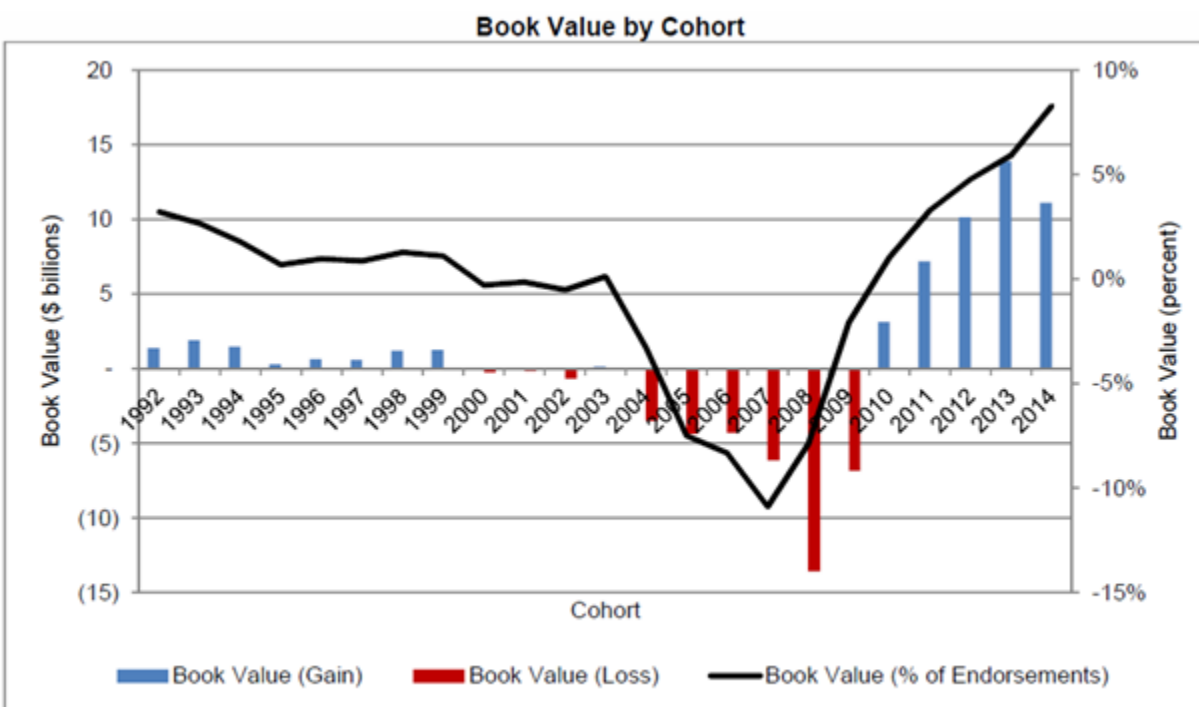
As HUD Secretary Julián Castro explained in his recent remarks to this committee, after FHA analyzed the effect of these increases, their data showed that the increases had resulted in FHA collecting about \$17 thousand from each borrower to cover projected risk of less than \$5 thousand.<sup>43</sup> This massive overcharging was negatively affecting FHA's mortgage volume, and while it is possible that some borrowers may have gone to the conventional market, given how many FHA borrowers cannot access the conventional market, it appeared more likely that otherwise underserved borrowers were simply not accessing the market at all. Additionally, especially as Fannie Mae and Freddie Mac reduce their own down payment requirements, FHA has an obligation to ensure the credit quality of its entire book of business, which means avoiding excessive adverse selection.

In short, correcting the pricing to meet the homeownership needs of its target market and to ensure the credit quality of its business is as important within the context of the statute as reaching the required capital ratio, especially when it is done in a way that does not significantly alter progress toward reaching the ratio. Considering that the 1990 statute initially gave FHA 10 years to grow its reserves to the 2 percent level, expecting FHA to return to that level far more rapidly after the worst economic downturn since the Great Depression is unrealistic and could put the taxpayer at increased, not decreased, risk.

Beyond the question of the premium reduction, it's important to understand exactly what the actuary is measuring and what the capital reserve ratio means. The actuary takes a very conservative approach, examining whether, if the agency were to stop insuring loans today, it has enough cash and reserves on hand to meet all of its existing insurance obligations. The 2 percent standard is unrelated to whether the agency has sufficient cash on hand to meet day-to-day obligations; the 46 billion it has is projected to be more than enough.<sup>44</sup> The 2 percent capital reserve ratio refers to a rainy-day fund, or a cushion, *over and above* the amount that the actuary currently believes is necessary to pay claims.

In the case of FHA, evaluating its financial position without accounting for its future business is especially conservative given that the agency's future business is likely to be far more profitable than in the past. The increased premiums FHA is collecting (even after the recently announced premium reduction), the policy and process improvements that are detailed in the previous section of this testimony, and the very high credit quality loans on its books are leading to record profits.<sup>45</sup> For example, the number of borrowers with credit scores below 620 has declined precipitously since 2008.<sup>46</sup> Loans insured from FY 2010 through 2014 are expected to contribute \$45 billion to the fund over their lifetime (see Figure 4).

Figure 4:



SOURCE: FY 2014 Actuarial Review of the MMI Fund; analysis by U.S. Department of HUD/FHA.

Other indicators of high-quality business include the following:

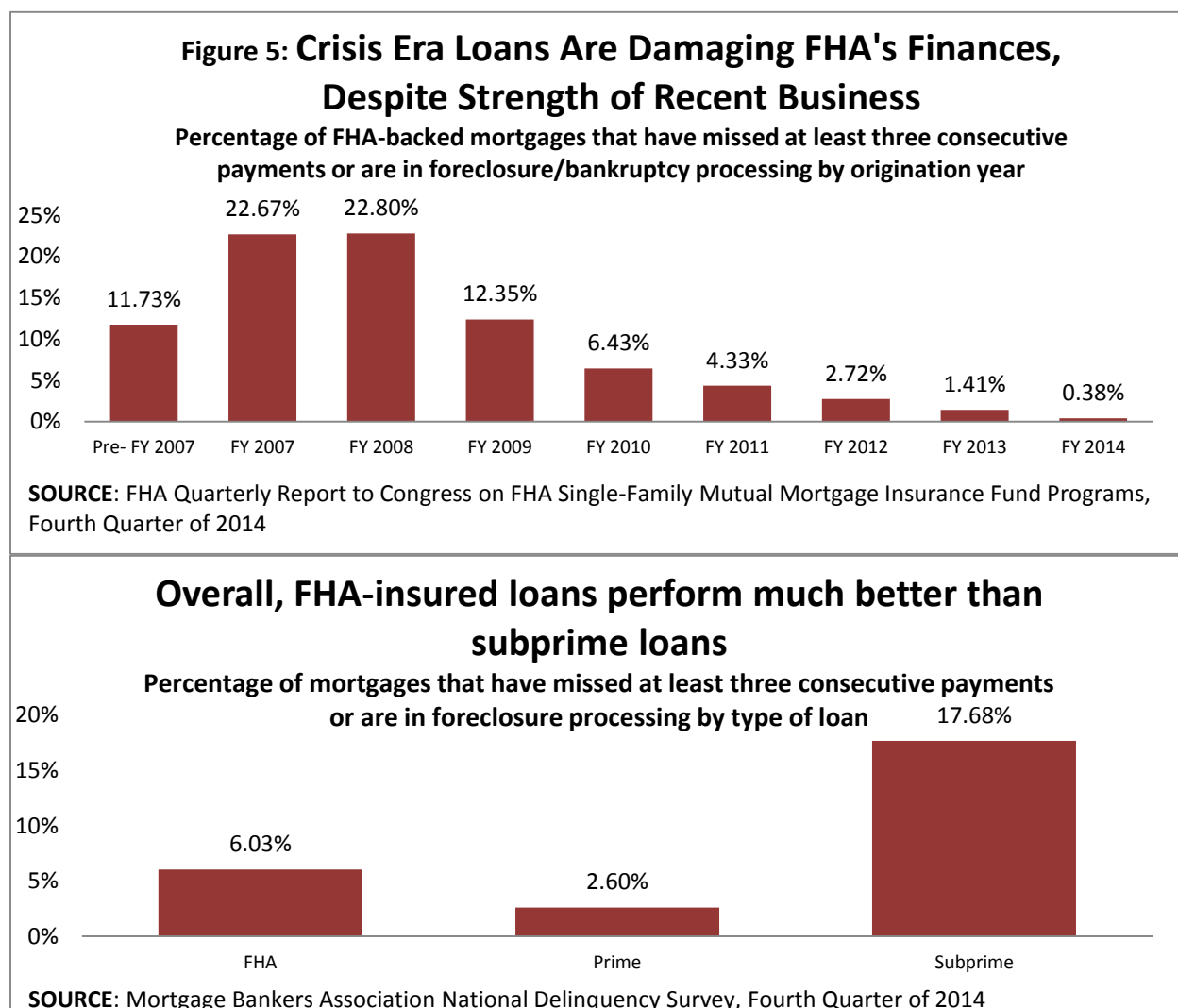
- A 13 percent improvement in serious delinquency rates since last year.
- Loans insured in FY 2010 through 2013 are four times less likely to be seriously delinquent than loans insured from FY 2007 to 2009.
- Recovery rates—the amount of an insurance claim FHA can recover through actions such as home sales—have improved by 64 percent over the past two years.<sup>47</sup>
- Early payment delinquency rates—which is the rate at which borrowers miss three payments in the first six months after origination, and a good measure of whether the agency is insuring bad loans—have declined dramatically from about 2 percent in 2007 to only one-quarter of a percent in 2013.
- FHA’s failure rate—the sum of to-date claims and loans in foreclosure—continues to improve for each subsequent book of business.<sup>48</sup>

Note that the excellent performance of the loans described above is based on business that consists predominantly of low down payment loans made to households with credit scores typical of the American public. In FY 2014, 75 percent of borrowers had loan-to-value ratios above 95 percent, and the median borrower credit score was 680, which demonstrates the ongoing strength of the core FHA business model.

It is also likely that FHA’s financial position will continue to improve because the strains of recent years were primarily due to projected and realized losses from FY 2007 through 2009 loans—loans strongly impacted by the recession and increases in unemployment, declining

home price values, and low levels of premium revenue. (see Figure 5) During those years, FHA was ramping up its production 450 percent to compensate for the virtual collapse of private-label loans, realizing that investing in these loans would likely lead to losses, but those losses would pale in comparison to the losses suffered if the market were allowed to experience a devastating collapse.<sup>49</sup>

As noted previously, a significant portion of these losses stem directly from the seller-funded down payment assistance program, which is expected to lead to 25 percent of the losses in the 2007–2009 books and ultimately cost the agency \$16 billion dollars in losses, according to the independent actuary.<sup>50</sup> If not for these loans, FHA would be significantly closer to meeting the 2 percent capital ratio, and it is unlikely it the agency would have required a draw from the Treasury.



Another significant contributor to FHA’s financial weakness has been its reverse mortgage portfolio, which currently has an economic value of negative 1.17 billion. The new estimated

value for reverse loans is a decline from the FY 2013 value, a decline primarily driven by expectations for higher interest rates in the long term. Due to the nature of reverse mortgages, most default risk lies far in the future, meaning that their value is extremely sensitive to small changes in interest rate expectations.<sup>51</sup>

Here too, FHA has made policy changes that will help its financial position, as noted previously. As a result of these changes, the independent actuary projects that the next five years of reverse mortgage originations will be profitable for FHA, which will reduce the shortfall FHA faces on this business line.<sup>52</sup>

### **III. Recommendations moving forward**

While FHA has taken critical actions to protect taxpayers, strengthen their risk management, and ensure borrowers receive loans in which they can succeed, additional steps are still needed. We believe these steps will further reduce risk to the taxpayer while enhancing access to mortgage credit for qualified households and strengthening neighborhoods.

One very important way in which FHA lending could be made even safer is to encourage and fund broader availability of housing counseling. FHA had developed a pilot program to do so called the Homeowners Armed with Knowledge, or HAWK, program. HAWK would have connected new homebuyers with high-quality housing counseling in exchange for a reduction in mortgage insurance premiums. The program made good economic sense: Research suggests that pre-purchase housing counseling can play an important role in reducing loan delinquency rates, likely by ensuring that borrowers understand the risks and costs of homeownership and by encouraging borrowers to buy a home they can afford.<sup>53</sup> HAWK also included a yet-to-be-introduced component that would link troubled borrowers with housing counselors, which significantly improves a homeowner's chance of avoiding foreclosure.<sup>54</sup>

Unfortunately, Congress used the FY 2015 spending bill to prohibit HUD from implementing HAWK,<sup>55</sup> although due to the nature of the vote, there was no meaningful discussion or debate about the merits of the program. CAP strongly recommends that Congress reconsider this decision and discuss whether FHA could implement the program in a way that Congress would support.

Congress should also support FHA's ability to invest in its infrastructure and quality assurance processes. The administrative fee proposed in the administration's FY 2015 and 2016 budgets could serve as a starting point for discussions.<sup>56</sup> In the meantime, Congress can enable FHA to better manage its counterparties by giving the agency the authority it has requested to better monitor and enforce lender and servicer compliance, including enhanced indemnification authority, expanded authority to terminate lenders, and the authority to transfer servicing from underperforming servicers.

To encourage lenders to serve more borrowers, FHA should complete its work on its Quality Assurance Taxonomy and certification process, and it should also complete work on creating a supplemental performance metric as a companion to the Compare Ratio<sup>57</sup> that will take FHA's

target mix of borrower characteristics into account when evaluating the performance of a lender's loans. By reducing lender uncertainty and combating misaligned incentives for lenders, each of these efforts will help expand access to credit for creditworthy borrowers who meet FHA's underwriting requirements. Congress can further support these efforts by giving FHA the authority it needs to modify the Compare Ratio.

While FHA has recently updated its loss mitigation requirements, including a revised set of alternatives to foreclosure that every servicer must consider before completing a foreclosure, many servicers do not appear to be complying with these rules. FHA should therefore require that a servicer provide clear proof that it complied with these new guidelines before it pays out an insurance claim. FHA also should require that its loan servicers give homeowners notice describing FHA's loss mitigation option and develop an effective mechanism through which homeowners can address a servicer's noncompliance with FHA's loss mitigation requirements. Additionally, as FHA continues developing its handbooks, it should continue to work with homeowner representatives to clarify important issues covered by the servicing handbook, such as treatment of successors-in-interest, the effect of bankruptcy, and relation of the handbook to existing regulations.

We also suggest the following improvements to the DASP note sales program.<sup>58</sup>

- FHA should require all buyers to work with existing homeowners to keep them in their homes if possible through a sustainable, permanent loan modification or to provide them with a foreclosure alternative such as a short sale or deed-in-lieu of foreclosure if a modification is not possible—perhaps using the Treasury Department's Making Home Affordable program.
- For properties where foreclosure cannot be avoided, FHA should require buyers to prioritize selling to owner-occupants, donating them to a nonprofit or local government or converting them into a well-maintained, affordable rental unit.<sup>59</sup>
- FHA should help nonprofits participate effectively in the bidding process because neighborhood-based nonprofits often produce the best outcomes for families and neighborhoods.
- Before placing loans in a sale pool, FHA should ensure that mortgage servicers have fully complied with the agency's requirements for attempting to assist borrowers and that the home is still occupied before placing a loan into distressed mortgage sale programs.
- FHA should collect and share more detailed performance data about the programs so the public can fully understand their effectiveness.

Another way that FHA can help hard-hit neighborhoods is to improve its mortgage product for homes that need rehabilitation, which is known as the 203(k) program. This program allows homebuyers to include renovation and repair costs in their mortgage. Beyond improving it for individual homeowners, FHA could provide expanded access to the program for nonprofit affordable-housing and community development groups.

To further improve reverse mortgages, HUD should provide meaningful protection for surviving spouses when they are not named on the loan to prevent them from losing their home at a very vulnerable time of life. Recently, HUD developed an option that would allow for the early assignment of the HECM mortgages at issue to the agency.<sup>60</sup> Unfortunately, most surviving spouses will not be able to use this option, both because many will not be able to come up with the funds necessary to qualify for the option and because a lender has discretion whether or not to permit this option.

In terms of involving private capital, if FHA considers pursuing single-family risk sharing as a means to more accurate pricing of FHA insurance and more protection of taxpayers, policymakers need to proceed cautiously and learn from the past. Previous programs of this nature have harmed FHA's bottom line due to improper alignment of incentives and considerations of the different objectives of counterparties.<sup>61</sup>

FHA has both a business and public policy function: it runs a large insurance company and should do so in a prudent and fiscally responsible manner. But its overarching mission is to serve borrowers and communities rather than to return a profit to shareholders. Private counterparties will focus only on the bottom line, which can be an effective force when properly harnessed but can sometimes conflict with FHA's policy goals. It is also important that private capital not cream profits in a way that would destabilize the insurance fund. Because of these different missions, it might make more sense to involve private capital and PMI companies in the national housing market through expanding the risk-sharing opportunities at Fannie Mae and Freddie Mac rather than through FHA.

However, if FHA moves in this direction, it should structure any efforts at risk sharing very deliberately to advance rather than compromise its mission. The agency will need to establish strong standards for counterparties, have the resources to adequately police these counterparties, and have the political independence necessary to enter into only those agreements that make sense and to terminate partnerships with bad partners as needed.

Finally, FHA should continue to explore how to improve risk estimates on FHA insurance. However, it would be a mistake to approach this problem by intentionally inflating the cost of that risk through so-called fair-value budget reporting. Instead of improving the accuracy of cost estimates for credit programs, it actually makes them less accurate by biasing apparent costs upward, and distorts the government's true fiscal position.<sup>62</sup> According to a recent analysis by Enterprise Community Partners, a shift to fair-value reporting would cost FHA \$18 billion in resources, which could seriously limit FHA's availability to the market.<sup>63</sup> In other words, it could cause serious harm to programs such as FHA while doing nothing to actually reduce taxpayer exposure to loss.

## Conclusion

FHA plays a key role in helping creditworthy homebuyers—especially those of modest means—obtain access to credit to purchase a home. Owning a home provides economic and social stability for middle-class families, builds wealth that can be leveraged and transferred across generations, and encourages residents to maintain their properties and invest in their communities.

In recent years, FHA has worked hard to balance its mission of supporting homeownership with its obligation to protect the insurance fund in a dynamic environment. Just as the significant increases in premiums over the past several years helped reverse the downward financial trajectory, the recent recalibration of the premium will help ensure that FHA continues to be available to the underserved borrowers that most need it.

Additionally, today's hearing highlights the importance of a continued conversation about the future of housing finance in America across all channels. Fannie and Freddie cannot remain in conservatorship indefinitely, and the market needs a steady supply of first-time homebuyers who can then become move-up homebuyers. Many of these buyers will be people of color or young people shouldering student debt, and they may not have the means to put 20 percent down. Important questions must be resolved about how to bring private capital back into the market, how to minimize government and taxpayer support while still providing long-term, sustainable lending, and how to serve the buyers of the future.

I welcome the opportunity to discuss these important matters with you in the coming months. Thank you again for inviting me today, and I look forward to your questions.



## Endnotes

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- <sup>11</sup> *Dodd-Frank Wall Street and Consumer Protection Act*, Public Law 111-203, 111<sup>th</sup> Congress, 2<sup>nd</sup> Session (July 21, 2010), Section 1412. The primary difference between the CFPB and FHA's qualified mortgage definition is that FHA does not have a bright-line cut-off of 43 percent debt-to-income ratio, instead requiring manual underwriting for many loans in that category.
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- <sup>44</sup> *Ibid.*
- <sup>45</sup> U.S. Department of Housing and Urban Development, “Summary of FY2014 FHA Annual Report to Congress on the Financial Health of the Mutual Mortgage Insurance Fund;” John Griffith, “After a Rough Few Years, FHA’s Financial Future Looks Promising,” *Enterprise Housing Horizon*, September 29, 2014, available at <http://blog.enterprisecommunity.com/2014/09/after-a-rough-few-years-fhas-financial-future-looks-promising>.
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