



Statement of
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On behalf of the
Mortgage Bankers Association

Senate Committee on Banking, Housing and Urban Affairs
“Addressing FHA’s Financial Condition and Program
Challenges, Part II”

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Chairman Johnson, Ranking Member Crapo and members of the committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA) on the recent release of the Federal Housing Administration's (FHA) Fiscal Year (FY) 2012 Actuarial Review, and its findings on the state of the Mutual Mortgage Insurance (MMI) Fund.

My name is David H. Stevens, and I am the President and CEO of the MBA. From 2009 to 2011, I served as Assistant Secretary for Housing and FHA Commissioner at the U.S. Department of Housing and Urban Development (HUD). Thank you for holding this hearing on the actuarial soundness of FHA's single-family insurance fund.

Given that professional experience, and my almost 30 years in real estate finance, I understand the importance of having a strong, capable leader to navigate the agency through this difficult time in FHA's history. I commend the Senate for confirming Carol Galante as FHA Commissioner at year's end. Commissioner Galante has been a staunch advocate for housing throughout her career, and I know she will work tirelessly to protect taxpayers and return FHA to sound financial footing. The changes she has announced to date provide comfort that the agency is moving aggressively and in the right direction.

FHA made headlines at the end of 2012 following the revelation that its MMI Fund, which holds the accounts for the single-family programs, had a negative capital ratio. Conversely, FHA's multifamily rental and healthcare programs, which are supported by HUD's General and Special Risk Insurance Fund, are fiscally sound. The Actuarial Review of the FHA MMI Fund Forward Loans for Fiscal Year 2012, released by HUD on November 16, 2012, confirmed that FHA, like most participants in the mortgage market, is still dealing with fallout from the recent housing crisis. FHA's problems may be exacerbated by its traditional countercyclical role and programmatic focus on underserved, minority and first-time homebuyers who may not be able to meet the downpayment or household wealth requirements for private loans.

MBA firmly believes that FHA has a vital role in the United States' housing finance system and its mission of serving first-time homebuyers and underserved populations and playing a countercyclical role should continue. Since its inception in 1934, FHA has enabled more than 40 million families to become homeowners.¹ In FY 2012, 77 percent of FHA purchase endorsements were to first-time homebuyers and 33 percent were to minority homebuyers. According to HMDA data, in 2011, 56 percent of African American homebuyers, and almost 59 percent of Hispanic homebuyers financed their purchases with FHA loans.² In 2012, applications for government refinance loans (primarily FHA) were almost 15 percent of all refinance applications, while applications for government loans to purchase a home were 37 percent of all purchase applications.³ Thus, recent data confirm that FHA continues to play an especially critical role in providing homeownership opportunities.

Given FHA's negative financial position, this is the proper time to reexamine U.S. housing policy. The policy decisions made today will help determine FHA's financial solvency, and whether it can continue to fulfill its traditional mission without taxpayer support. Congress, the Obama administration, and other stakeholders will need to consider requisite trade-offs that seek to balance FHA's financial stability against the maintenance of a program that facilitates

¹ U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 11. Can be accessed at: <http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>.

² MBA analysis of 2011 HMDA data.

³ Data compiled from MBA Weekly Applications Surveys.

homeownership for slightly higher risk consumers who might not otherwise be able to qualify for a loan. It is within this context that MBA provides this statement evaluating various policy options that FHA could undertake to ensure its long-term viability.

FHA and its Role in the Housing Market

FHA has played an important countercyclical role in the mortgage markets, both historically and in the most recent housing downturn. As private market credit risk appetites grew during the pre-crisis years, FHA began to lose market share. FHA's market share significantly declined during the early 2000s, a period when the private market was experiencing significant growth due to alternative mortgage products and a rise in demand for private label mortgage-backed securities.

Many of FHA's traditional borrowers – low-wealth families with minimal funds for a downpayment – left FHA during the housing boom for subprime and other loans that provided lower initial monthly payments. As the housing markets heated up, FHA's fully documented underwriting was perceived as overly onerous and bureaucratic. From 2003 until 2007, FHA's share of the mortgage market hovered between two and seven percent.⁴ Its flagship 30-year fixed-rate mortgage was shunned by many borrowers looking for lower initial mortgage payments. In addition to FHA's more stringent underwriting standards, there was a general belief by many market participants, lenders and borrowers alike, that FHA-insured loans were too time-consuming, expensive, and complicated compared to conventional or subprime loans. As a result, FHA was not the first choice for many real estate borrowers, brokers and lenders.

During this explosion of subprime lending, FHA was further weighed down by seller-funded downpayment assistance programs, which proved to be extremely costly to the MMI Fund. These programs often resulted in inflated property values and real loan-to-values in excess of 100 percent. These seller-funded downpayment assistance program loans have performed two to three times worse than typical FHA-insured loans, and still represent an expected drain on the Fund of about \$15 billion in the years ahead.⁵ The Actuary estimates that if seller-funded downpayment loans were not in FHA's portfolio, the net economic value of the MMI Fund would be positive \$1.77 billion.⁶

As the housing market began to tumble in 2007, the private label market contracted precipitously and lenders began to shift as much production as possible to FHA, Fannie Mae, and Freddie Mac. The Economic Stimulus Act of 2008 increased both conventional and FHA loan limits throughout the country and especially in high-cost areas. Approximately 75 of the highest cost counties in the nation saw the FHA loan limits more than double from \$362,790 to \$729,750. Another 500 counties had new loan limits set between \$280,000 and \$729,750. The remaining 2,500 counties had new loan limits of \$280,000, up from \$200,000. The once dormant FHA experienced high demand from coast to coast.⁷ At the height of the housing crisis

⁴ U.S. Dept. of Housing and Urban Development, FHA Single Family Activity in the Home-Purchase Market Through June 2012. Can be accessed at:

<http://portal.hud.gov/hudportal/documents/huddoc?id=fhamkt0612.pdf>.

⁵ U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 7. Can be accessed at:

<http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>.

⁶ *Ibid* at p. 25.

⁷ Mortgage Bankers Association, The Future of the Federal Housing Administration and the Government National Mortgage Association (September 2010) at p. 26. Can be accessed at:

<http://www.mortgagebankers.org/files/ResourceCenter/FHA/TheFutureofFHAandGinnieMae.pdf>.

in 2009 government loans accounted for over 40 percent of the purchase market compared to 34 percent today.⁸ Most of these loans were FHA-insured. Performing this countercyclical role, however, has proven costly for FHA as its post-crisis books-of-business, 2008 and 2009 vintage loans, continue to show very significant losses, as reflected in the FY 2012 Actuarial Review.

FY 2012 Actuarial Review

The Actuarial Review provides an annual assessment of the fiscal health of the FHA and its financial outlook at a particular point in time. The FY 2012 Review showed that the capital ratio of the MMI Fund had fallen to negative 1.44 percent, well below its statutory 2 percent requirement. In the FY 2011 Review, the ratio was 0.24 percent, and the ratio for the prior two years had been below the statutory 2 percent minimum as well. The news that the capital ratio had turned negative prompted immediate concerns that FHA might need a draw from the U.S. Treasury (Treasury) - the first in the agency's history - and called into sharp focus whether FHA's policies need to be adjusted.

Highlights of the Actuarial Review include:

- The negative 1.44 percent ratio represents a negative economic value of \$16.3 billion. This is the first time the Fund has been negative since the early 1990s.
- The *economic value* indicates the amount of resources the fund has over and above the reserve held for expected losses.
- The Actuarial Review cites several important reasons for the decline in the capital reserve ratio, including:
 - A less optimistic House Price Appreciation (HPA) forecast since last year (\$10.5 billion reduction).
 - Lower historic and projected path for interest rates (\$8 billion reduction). More borrowers are projected to pay off their mortgages, which reduces future revenues on the current portfolio.
 - Refinements to the forecasting model (\$10 billion on the forward mortgage portfolio; \$3 billion on HECM loans). Following recommendations by the GAO, HUD's Inspector General, and others, the actuary changed the way it calculates losses on defaulted loans. This change in methodology resulted in an estimated \$13 billion in reduced economic value compared to last year's projections. Previous models did not adequately model the differential loss severities of pre-foreclosure sales (short sales) versus conveyances (REO sales). In particular, last year's model did not apply large enough loss severities for very high LTV loans. This year's Review takes a more comprehensive approach towards the modeling of previously modified loans.
- The total *capital resources* of the Fund at the end of FY 2012 were estimated to be \$30.4 billion.
- The Actuarial Review finds that there is a five percent chance over the next few years that *capital resources* will go negative.
- Focusing on the forward portfolio, as of the end of FY 2012, the Fund is projected to have an estimated economic value of negative \$13.48 billion, an unamortized Insurance-in-Force (IIF) of \$1,126.27 billion and amortized IIF of \$1,053.33 billion.

⁸ Data compiled from MBA Weekly Applications Surveys.

- The economic value of the 2007-2009 books of business is negative 7 percent while the economic value of the 2010-2012 books of business is positive 3 percent.
- The FY 2012 book of business is projected to contribute an estimated \$11.92 billion in present value to the economic value of the Fund.
- The economic value is projected to increase over the next seven years to reach \$54.25 billion by the end of FY 2019. However, this estimate is subject to assumptions regarding the volume and composition of future books of business.
- HUD also reports that the Home Equity Conversion Mortgage (HECM), FHA's reverse mortgage program, portfolio has a negative economic value, negative 3.5 percent. Adding the economic value of the forward mortgage and HECM program produces a total economic value of negative \$16.3 billion.

Importantly, these findings do not mean that FHA has insufficient cash to pay insurance claims, a current operating deficit, or will need to immediately draw funds from Treasury. Indeed, the Actuarial Review itself does not determine if FHA needs a draw from Treasury; that need is determined by the economic assumptions used in the President's FY 2014 budget proposal. The final determination on a potential draw will be made in September 2013.

Given that the country just went through a severe recession from which it is still recovering, it is not surprising that FHA is experiencing significant losses on loans made during the crisis, as well as losses on the large volume of new business. High unemployment, steep home price declines and the seller-funded downpayment assistance program loans weighed heavily on the MMI Fund. The Actuarial Review estimates that the forward loan portfolio in MMI Fund may not be positive until 2014, and will reach the statutory two percent threshold some time in FY 2017; the HECM portfolio is not projected to be positive within the timeframe of the Actuarial Review.⁹

MBA has reviewed the audits of the MMI Fund. These audits used a wealth of data and sophisticated modeling techniques. MBA believes that minor specification changes in the default model, or subtle differences in the treatment of the data, would not have yielded significantly different results. Uncertainty regarding the economy is a more important factor.

With regard to economic uncertainty, MBA wishes to underscore that the soundness of FHA's financial position is intricately tied to whether the assumptions and predictions that were used as the basis for the Actuarial Review hold true. While the industry is cautiously optimistic about FHA's recent programmatic changes, MBA recognizes the severity of the losses stemming from the 2007-2009 books of business are so great, and the uncertainty in forecasting economic trends is so high, that the possibility of a further decline in the capital ratio must be acknowledged.

Moreover, assumptions regarding certain key variables, including the future paths of home prices and interest rates, can significantly sway the estimate of Fund value in either direction.

Importantly, FHA's capital adequacy requirements are designed to be analogous to those for private institutions – they minimize the likelihood that taxpayers would need to provide funds to FHA. For a private sector financial institution, regulatory capital measures are a key indicator of financial health. Banks and other financial institutions set aside reserves to cover expected losses on lending, but also hold capital to cover unexpected losses that may arise from changes

⁹ U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 46. Can be accessed at: <http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>.

in economic or financial market conditions or loan performance. Regulators require financial institutions to hold sufficient capital to minimize the likelihood that they would become insolvent during a crisis. FHA's requirements are modeled after these sound and proven practices, although, clearly the recent crisis has taken a severe toll on the FHA's financial stability which may require additional programmatic changes.

National Delinquency Survey Recap from Fourth Quarter 2012

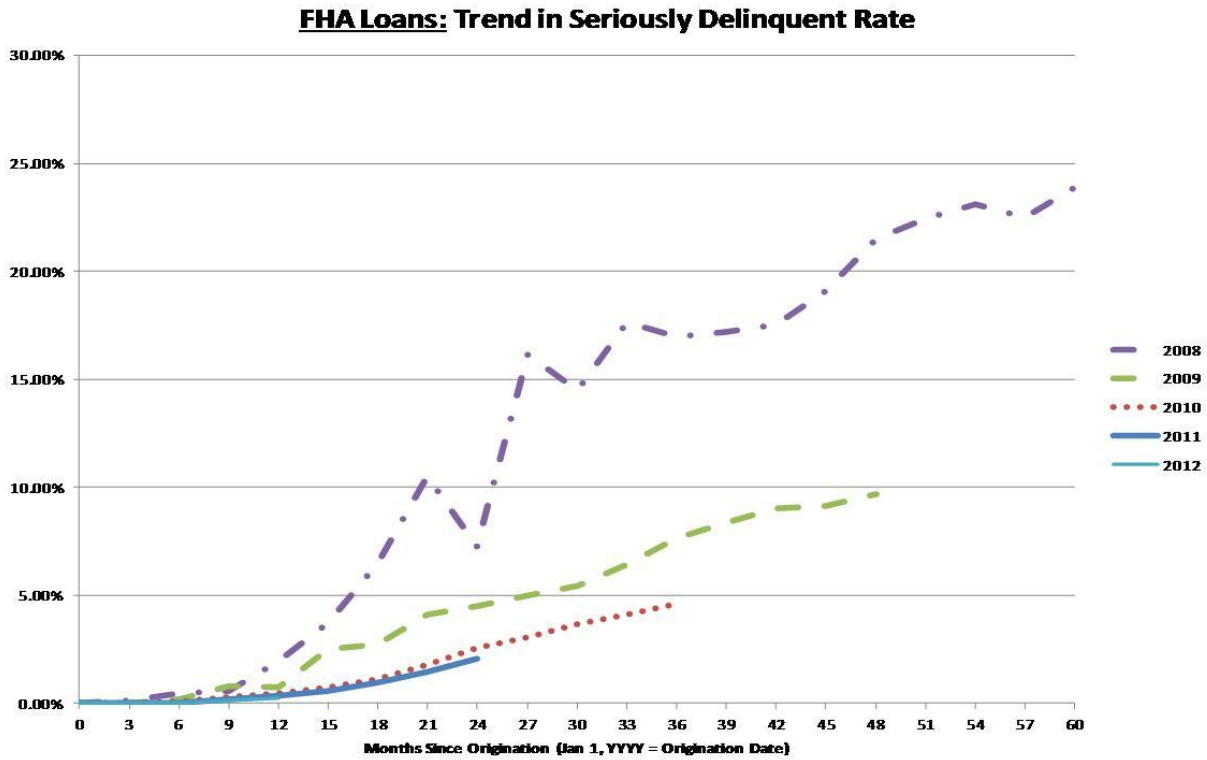
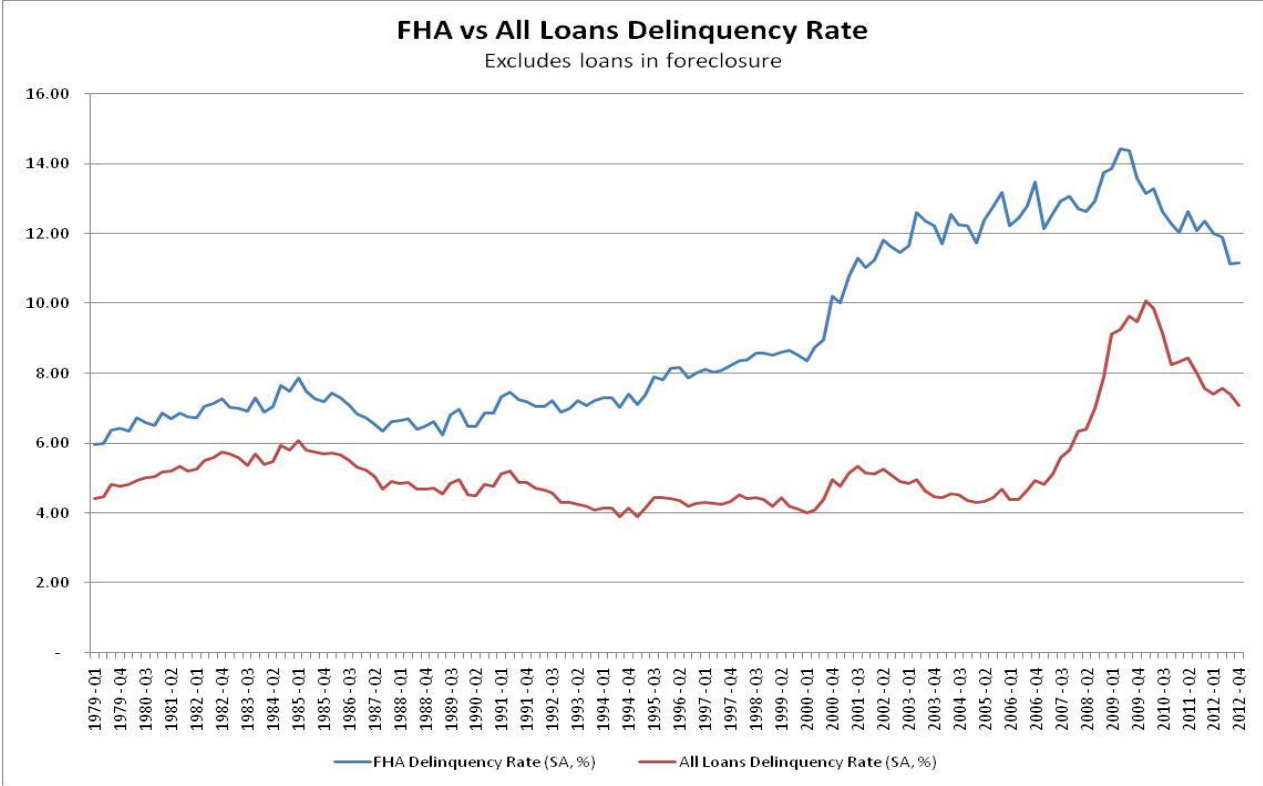
On February 21, 2013, MBA released its fourth quarter 2012 National Delinquency Survey (NDS) results. There were large improvements in mortgage performance nationally and in almost every state. The 30-day delinquency rate decreased 21 basis points to its lowest level since mid-2007. With fewer new delinquencies, the foreclosure start rate and foreclosure inventory rates continued to fall and are at their lowest levels since 2007 and 2008, respectively. Overall, we believe that these improvements in market conditions bode well for FHA as it works to improve its financial situation.

The foreclosure starts rate decreased by the largest amount ever in the MBA survey and now stands at half of its peak in 2009. Similarly, the 33 basis point drop in the foreclosure inventory rate is also the largest in the history of the survey. One cautionary note is that the 90+ delinquency rate increased by eight basis points, reversing a fairly steady pattern of decline and the largest increase in this rate in three years. While we normally see an increase in this rate in individual states when they change their foreclosure laws, 38 states had increases in the percentage of loans three payments or more past due, indicating that we could see a modest increase in foreclosure starts in subsequent quarters.

The two biggest factors impacting the number of loans in the foreclosure process still are the magnitude of the problem in Florida and the judicial foreclosure systems in some states. Twelve percent of the mortgages in Florida are in the process of foreclosure, down from a peak of 14.5 percent last year but still an extraordinarily high rate that is impacting the national rate. Florida accounts for almost 24 percent of all loans in foreclosure in the nation, but only 7.4 percent of loans serviced. In addition, while the percentages of loans in foreclosure dropped in almost all states, the average rate for judicial states was 6.2 percent – triple the average rate of 2.1 percent for non-judicial states. In those cases, the ultimate reduction in the number of loans in foreclosure will have less to do with the recovery of the economy and the housing market than with the return to reasonable foreclosure timelines.

The performance of FHA loans was mixed. While the foreclosure starts and foreclosure inventory percentages both fell, the delinquency percentages generally remained flat or increased slightly, particularly the percentage of loans 90 days or more past due. The other loan types generally saw declines in delinquency rates in the fourth quarter. However, 44 percent of FHA loans that are seriously delinquent were made in the years 2008 and 2009, while loans made in those years represent a smaller share of FHA's overall book of business.

After large third quarter increases in the foreclosure starts and inventory rates for FHA loans due to actions by some large servicers to re-start foreclosure processes that had been temporarily halted, these rates fell in the fourth quarter. The percent of loans in foreclosure for FHA loans decreased to 3.85 percent, and FHA foreclosure starts decreased to 0.86 percent. The percent of FHA loans in foreclosure was almost 40 basis points lower than the record high of Q2 2012, but remained well above historical averages.



Recent FHA Policy Changes

FHA has made a series of single-family risk management and lender oversight and enforcement changes over the last two years, such as raising the annual mortgage insurance premium several times, increasing downpayment requirements from 3.5 percent to 10 percent for borrowers with credit scores below 580, eliminating FHA's approval of loan correspondents, raising lender net worth requirements in all programs, re-examining HECM policies, and establishing the Office of Risk Management. By making these changes, FHA has taken substantive steps over a short period of time to protect the Fund. The credit profile and performance of the FY 2010 to 2012 portfolios are testaments to these changes: the average FHA credit score for FY 2011 was 696¹⁰ and the delinquency rate was 2.07 percent in the fourth quarter of 2012.¹¹ Significant performance improvement in the Fund is especially notable in the 2010, 2011, and 2012 books of business.

More recently, in response to the FY 2012 Actuarial Review, FHA announced a series of program changes aimed at increasing revenue, reducing credit risk, and improving the management of the existing portfolio. MBA believes that these recent changes are fiscally prudent and warranted given the financial realities described in the Actuarial Review. In late January 2013, FHA announced the following administrative changes directly aimed at either increasing revenue or reducing credit risk:

1. Increase in the annual mortgage insurance premium (MIP) of 10 basis points for all forward loans, except streamline refinances effective for case number assigned on or after April 1, 2013.
2. Change in the MIP cancellation policy to require that most loans charge the MIP for the life of the loan, or 11 years, effective June 3, 2013 for loans with case number assigned on or after that date.
3. Change in credit policy to require that borrowers with credit scores under 620 must be manually underwritten, effective April 1, 2013.
4. Consolidation of the HECM Fixed-Rate Standard Program and HECM Saver Program, to allow borrowers to have the predictability of a fixed-rate, but with a lower upfront fee, effective April 1, 2013.

Looking forward, there is shared concern among industry, consumer groups, policymakers, and Congress that additional steps may be needed to ensure that FHA is financially secure for the long term. At the same time, some are concerned that recent decisions and potential upcoming programmatic changes may come at the expense of homeownership opportunities and potentially cutting off credit to vital sections of the market. Both sentiments are valid and deserve serious, thoughtful, and balanced consideration.

Policy Considerations

From MBA's perspective, further programmatic changes at FHA must balance three priorities:

1. Restoring financial solvency;
2. Preserving the housing mission; and

¹⁰ U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 18. Can be accessed at: <http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>.

¹¹ See Chart on page 7.

3. Maintaining its countercyclical role.

Congress and this administration face the challenge of striking a balance among these three goals. MBA is currently working with its members to evaluate the pros and cons of various policy options to determine which ones offer the greatest impact while meeting the aforementioned goals. These trade-offs are outlined in MBA's soon to be released white paper. Below are selected considerations from our findings.

Reducing or Eliminating Risk Layering

In underwriting borrowers, individual risk factors can sometimes be mitigated by compensating factors. FHA's traditional underwriting philosophy takes this approach. The key to further improving the credit quality of the portfolio going forward is to limit excessive risk layering. Doing so could make future FHA business even stronger than the 2010-2012 books. Congress and the administration, however, need to recognize that while the losses in the 2008 and 2009 books can be reduced and managed through better default management execution at FHA, changing credit standards on future books will not lower these embedded losses, and may actually harm the housing market recovery.

Risk-based underwriting, or specifying particular underwriting criteria within certain credit boundaries, could be structured in various ways to reduce FHA's credit risk. As indicated below, the social consequences could be significant if FHA employs overly stringent credit controls. Thus, finding the right balance is critical.

Downpayment Requirement

A risk management method that FHA has already begun to employ is to tier downpayment with credit scores and possibly other loan characteristics. Increasing FHA's minimum downpayment requirement would immediately improve FHA's risk profile on new business. An increase of the minimum downpayment from 3.5 percent to 5 percent would reduce expected losses to the MMI Fund through lower default rates and lower loss severity in the event of default. This step would increase the economic value of future books of business, but obviously would do nothing to reduce losses already on the books. It should be noted that the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, price differently based on LTVs. For example, Fannie Mae charges an additional loan level price adjustment of 50 basis points for loans with LTVs between 95 and 97 percent.

FHA has made similar policy changes that increase minimum downpayments for certain borrowers. A borrower with a credit score below 580 is required to have a 10 percent downpayment. Additionally, HUD has proposed raising the minimum downpayment for borrowers with loans above \$625,500 to five percent.

FHA could continue this trend by designing a tiered downpayment structure based on credit scores where borrowers with the greatest risk of defaulting would be required to pay higher downpayments than borrowers with better credit scores. A borrower's credit score is a predictor of probability of default. FHA could consider a structure similar to the following: 3.5 percent minimum downpayment for borrowers with credit scores 620 and greater; 10 percent minimum downpayment for borrowers with credit scores between 580 and 620; 15 percent downpayment for borrowers with credit scores less than 580.

Changing the singular downpayment structure in a way that is contrary to the average pricing/cross-subsidization model that currently exists could make mortgages less affordable for borrowers on the margins. Furthermore, it is not clear whether a borrower who could accumulate a 10 percent downpayment would still choose a FHA loan, which could lead to the loss of higher quality borrowers.

In short, the social consequences of increasing the minimum downpayment requirement could be dramatic. An increase would unnecessarily delay a purchase for many Americans who might be successful homeowners, with the greatest impact falling on the underserved. In particular, a tiered downpayment structure would place a greater financial burden on borrowers who may have the least amount of savings.

Credit Score Floor

In response to the FY 2012 Actuarial Review, FHA is requiring borrowers with credit scores below 620 to have a maximum debt-to-income ratio no greater than 43 percent in order for their loan applications to be approved through FHA's TOTAL Scorecard, an automated system used by FHA-approved lenders to score the quality of an FHA loan application.¹² Borrowers with credit scores and DTI ratios that do not meet these requirements may still obtain an FHA-insured loan, but their loan application must be manually underwritten by the lender to ensure adequate compensating factors.

Raising the minimum credit score to 620 for all borrowers would reflect the current market standard of private lenders, making FHA less subject to adverse selection based on its credit policy. Importantly, credit scores are a major factor in evaluating the future performance of loans. As the most recent Actuarial Review indicates, there is a strong correlation between the credit score and loan performance. As the average FHA credit score has risen, performance of the corresponding books of business has greatly improved. Borrowers with extremely weak credit may be better served by credit counseling and a slower path to homeownership, rather than a costlier loan today.

A downside risk is that raising the minimum credit score to 620 could reduce affordable credit options for many borrowers, some of whom may have qualified for a loan had it not been for a one-time life event, such as job loss or medical expenses. FHA has been one of the few fully-underwritten and documented lending options for borrowers with impaired credit. Increasing eligibility standards may make the market fertile ground for the growth of a new subprime market and/or predatory lending.

Reserve and Debt-to-Income Requirements

Tightening FHA's credit box to require two month reserves and DTI requirements for all borrowers would promote even stronger performance than that seen in recent books. Reserves and DTI requirements for all borrowers would help homeowners absorb major household expenses, such as replacing a heating system or paying for a car repair. These changes would positively impact FHA's default rate and should reduce future claims. Moreover, this would be another way to verify if borrowers are truly financially prepared for the cost of homeownership.

¹² Letter from Acting Assistant Secretary for Housing, FHA Commissioner Carol Galante to Sen. Robert Corker, December 18, 2012. Can be accessed at: http://www.corker.senate.gov/public/_cache/files/940b16a2-a401-418f-b409-5dca6e176c42/12-18-12_Letter%20from_Carol_Galante.pdf.

Conversely, these changes would also delay homebuying for borrowers who would potentially need to accumulate additional cash for a downpayment.

High-Cost Loan Limits

In 2011, Congress extended the high-cost loan limits first enacted in the Economic Stimulus Act of 2008, thereby maintaining the FHA high-cost loan limit of \$729,750 until December 31, 2013. Importantly, this loan limit was only extended for FHA-insured loans; the GSE loan limit was lowered to \$625,500. According to MBA data, less than one percent of FHA-insured loans are between \$625,500 and \$729,750. FHA lending above \$625,500 is most prevalent in the following areas: Washington D.C. (12.9 percent); California (3.4 percent); Virginia (3.2 percent); and New York (3.1 percent).¹³

There is evidence that the demand for large loans is growing and that these borrowers will be adequately served by the private sector. According to MBA's Weekly Application Survey Data, there was a 22 percent increase in the number of loans between \$625,000 and \$729,000 from 2011 and 2012. As the demand for this market grows, the private sector will readily expand its offerings to qualified borrowers.

Allowing the current high-cost area loan limits to expire in 2013, and reducing them to the GSE loan limits, would help return FHA's focus to serving low-to-moderate income and first-time homebuyers. The expiration would not greatly affect national FHA lending and would expand the opportunity for private lenders to serve higher income borrowers.

On the other hand, according to FHA data, larger loans tend to perform better compared with smaller loans in the same geographical area. Also, borrowers are already charged an additional 25 basis points for these loans.¹⁴ Thus, these high-cost loans actually improve the performance of the MMI Fund and provide additional revenue. Given that loans above \$625,000 comprise a small percentage of FHA's portfolio, but have significant positive attributes, policymakers may consider extending the limits until the MMI Fund is financially stable.

While it would be rational to lower the high-cost FHA limits to focus the program on lower-income and lower-wealth borrowers, the question is when to make this change. It is also important to recognize that making this change is unlikely to contribute positively to the financial health of the Fund, but would primarily serve to refocus FHA on serving its core mission.

Lender Enforcement

In recent years, FHA has greatly increased its enforcement of agency-approved lenders. FHA has:

- Enhanced monitoring of lender performance and compliance with FHA guidelines and standards (Effective January 21, 2010).¹⁵

¹³ Data compiled from MBA Weekly Applications Surveys.

¹⁴ Integrated Financial Engineering, Inc., Actuarial Review of the Federal Housing Administration Mutual Mortgage Insurance Fund Forward Loans for Fiscal Year 2012 (November 2012) at p. 48. Can be accessed at: http://portal.hud.gov/hudportal/documents/huddoc?id=ar2012_forward_loans.pdf.

¹⁵ Mortgagee Letter 2010-02.

- Expanded the Credit Watch Termination Initiative to include evaluation of lender underwriting performance in addition to origination performance (Effective January 21, 2010).¹⁶
- Implemented its statutory authority through regulation of section 256 of the National Housing Act to enforce indemnification provisions for lender's using delegated insuring process (Effective February 24, 2012).¹⁷

According to HUD, heightened enforcement of its requirements for FHA-approved lenders has resulted in over 1,600 lenders being withdrawn from FHA's program as a result of violations of FHA approval, origination, or servicing requirements and the imposition of more than \$13.8 million in civil money penalties and administrative payments for FHA-approved lenders.¹⁸

Additionally, the U.S. Department of Justice (DOJ) has recently begun filing court actions against lenders under the False Claims Act (FCA). The FCA is a federal law that imposes liability on any person who knowingly presents a false or fraudulent claim for payment or approval to the U.S. government. These court actions are based on alleged false loan-level certifications and annual certifications by lenders. The penalties are severe – lenders can be liable for three times the damages sustained by HUD, plus civil penalties of up to \$11,000 per transaction. Since May 2011, HUD and the DOJ have filed and/or settled five cases against lenders, with settlement amounts ranging in four cases being \$132.8 million, \$158.3 million, \$202.3 and \$1 billion.¹⁹

The prospect of tough administrative and legal enforcement actions provides strong incentives for lenders to carefully follow FHA program guidelines. These enforcement actions also increase revenue for the MMI Fund.

There is a point, however, where harsh enforcement actions can have negative consequences for the FHA and eligible borrowers. While some in Congress and other policymakers may believe that additional FHA lender enforcement tools and legal actions were necessary to contend with some of the real and alleged lending abuses that occurred in the past by companies, it is undeniable that the increase in intensity of lender enforcement has contributed to lenders constricting credit. Blunt tools, such as "zero-tolerance" lender enforcement, only serve to cause lenders to restrict lending to qualified borrowers for fear that minor, unintentional, and immaterial mistakes will be used as reasons for requiring indemnifications, or worse, as the basis for a False Claims lawsuit. Indemnifications or a FCA lawsuit are problems for all lenders, but they could be catastrophic for smaller independent mortgage bankers and community banks.

When lenders must operate their businesses to near-perfect standards or potentially face substantial financial penalties, they will naturally restrict their underwriting to be well within the boundaries of cautious lending. Thus, overlays that include higher credit scores, lower debt-to-income ratios, and reserve requirements – all above and beyond the official FHA program guidelines – become necessary buffers to mitigate lender risk. This response from lenders directly impacts consumers by eliminating borrowers who could possibly be responsible

¹⁶ Mortgagee Letter 2010-03.

¹⁷ 24 CFR Part 203.

¹⁸ U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 61. Can be accessed at: <http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>

¹⁹ Schulman, P.L., Baugher, K. M. (2012). Triple Trouble. Mortgage Banking, 72 (10), pp. 61-62.

homeowners, but have a few risk factors. Given the high stakes of indemnification or lawsuits, it is difficult for lenders to justify taking a chance on marginal borrowers – FHA's targeted population.

Let me be clear: as FHA commissioner, I initiated tighter controls and enforcement procedures that shut down irresponsible FHA lenders. When warranted, this is the right thing to do for the Fund and the market. Dishonest or sloppy lenders have no place within the FHA program. However, FHA must take a balanced approach to enforcement; otherwise FHA's practices could risk lenders cutting off credit that is needed to help support the housing market recovery.

MBA unquestionably supports high standards for all lenders that participate in FHA programs in order to protect the agency's viability, the lender's reputation, and the reputation of the industry. MBA members recognize and accept accountability for instances of fraud and negligence within their control. Moreover, lenders take full responsibility for underwriting mistakes that lead to loan delinquencies and incorporate sophisticated quality control systems to minimize the possibility of indemnifications. There must, however, be a reasonable margin for human error, especially when the error is not the cause of the delinquency or default. MBA would staunchly oppose efforts that allow FHA to go beyond reasonable standards of lender enforcement.

Servicing Loss Mitigation

FHA has taken proactive, appropriate, and aggressive steps to manage its 2000 to 2009 books-of-business, which include the agency's most costly loans. MBA commends these efforts, given that FHA already holds the risk on the loans. MBA also recognizes that additional steps may be necessary to further minimize losses. Below are MBA's thoughts on various means FHA is judiciously employing or considering to further reduce losses.

Launch large-scale proactive modification and partial claim campaigns for delinquent borrowers

During recent years, HUD has promoted several programs to assist borrowers retain homeownership, including the introduction of FHA's Home Affordable Modification Program (HAMP), which help homeowners experiencing financial hardship make their homes more affordable by reducing the mortgage payment. Recently HUD made revisions to its loss mitigation home retention options making it easier for borrowers to qualify for FHA HAMP partial claims²⁰ and modifications.

Enhancing loan modifications and partial claims have the potential to achieve HUD's objective of helping more delinquent borrowers return to performing status on their mortgages and ultimately reducing losses from foreclosures. MBA is encouraged that this effort will yield positive results and truly make a difference for many borrowers.

MBA does recognize, however, that increasing the number of partial claims in the short-term will require more cash outlays from the MMI Fund. Unsuccessful partial claims are costly to the MMI Fund because they prolong the existence of non-performing loans and increase claim obligations, deterioration of the property and other liabilities. However, MBA anticipates that the

²⁰ Under the Partial Claim Option, the Lender will advance funds on behalf of the Borrower in an amount necessary to reinstate the delinquent loan. The Borrower will execute a Promissory Note and Subordinate Mortgage payable to HUD. Currently, these Promissory or "Partial Claim" Notes assess no interest and are not due and payable until the Borrower either pays off the first mortgage or no longer owns the property.

increase in partial claims and other loss mitigation solutions will result in long-term savings for HUD.

Encourage Pre-foreclosure Sales

A pre-foreclosure sale (PFS) is a “short sale” - a sale of the property in satisfaction of a defaulted mortgage even though the proceeds are less than the amount owed on the mortgage.

HUD has acknowledged that pre-foreclosure sales are beneficial in the economic recovery, as well as a cost-savings for HUD. For these reasons, HUD plans to take steps to encourage more pre-foreclosure sales as an alternative to foreclosure.

Pre-foreclosure sales allow homeowners a quick resolution of a mortgage loan in default without experiencing the foreclosure process. HUD benefits by avoiding long foreclosure and eviction periods during which debenture interest and claim expenses accumulate and when property damage can occur.

Modifying the rules on pre-foreclosure sales will allow borrowers who cannot and do not want to retain their homes dispose of them more quickly. However, modifying the rules also may increase strategic defaults by borrowers who are capable of repaying their debts. Such a result would increase overall losses for FHA. With proper controls, however, this risk can be minimized.

Enhance servicer performance management and oversight

HUD is in the process of implementing an enhanced servicer performance scorecard that we understand will include the following four core areas: i) foreclosure prevention; ii) loss mitigation engagement; iii) single-family default monitoring system (SFDMS) reporting; and iv) re-defaults. It is expected that the new scorecard will become the vehicle to determine loss mitigation incentives and treble damages for failing to engage in loss mitigation. Changes to the scorecard will require rulemaking and *Federal Register* notice and comment before they become effective. In addition, HUD will issue a Mortgagee Letter with further details.

The new scorecard changes how performance is measured, and will likely reduce HUD outlays of loss mitigation incentive payments for execution of loss mitigation and could increase the imposition of treble damages. This will affect servicers, which depend on loss mitigation incentives to cover the enhanced servicing obligations imposed on them to administer delinquent FHA borrowers. Also, we are concerned the new scorecard will provide, for the first time, a vehicle to impose treble damages for reporting issues and issues outside of the servicer’s controls (such as re-defaults) rather than on servicers’ efforts to offer loss mitigation. We do not believe treble damages are the appropriate remedy in these cases. The changes will result in the need for additional overlays in origination to reduce the risk of default, which in turn will reduce originations to FHA.

Accelerate Note Sales

As part of the effort to address the housing market’s “shadow inventory” and to target relief to communities with high foreclosure activity, HUD has accelerated the use of note sales through the Distressed Asset Stabilization Program (DASP). This program enables HUD to sell severely delinquent loans insured by the FHA through a competitive bidding process in which loans are sold to the highest bidder, including non-profit and community-based organizations.

HUD benefits from the program because it does not have the expense of an extended foreclosure process, saving considerable money for FHA's insurance fund. Borrowers benefit because the new note holders may have additional flexibilities to modify loans that FHA servicers do not have.

Home Equity Conversion Mortgage (HECM) Program

The independent actuary projects the economic value of the HECM ("reverse mortgage") portfolio to be negative \$2.8 billion, compared to \$1.4 billion in FY 2011. The major reasons for this steep decline are:

- Updated mortality and termination speeds. Expected termination rates are slower than projected last year, thereby reducing the economic value by \$1.9 billion. Survivorship beyond 10 years results in a greater chance of loan balances exceeding property values and HUD realizing a loss.
- Higher rate of property conveyance at termination. Presently, about 70 percent of non-refinance loan terminations result in the conveyance of properties to HUD compared to about 70 percent of property sales being handled directly by owners or real estate executors historically. The new actuarial estimates use updated projection model rates based on this new reality. The change reduces the value of the Fund by \$1.9 billion.
- Less optimistic baseline house appreciation rates. As discussed in the FY MMI Actuarial section, home price appreciations have been revised since the FY2011 Actuarial Review.²¹

In response to the actuary findings, HUD has announced significant changes to the HECM program. Effective April 1, 2013, FHA consolidated the Fixed Rate Standard program with the HECM Saver product, thus reducing the maximum amount of funds available to the borrower.²² The Fixed Rate Standard was attractive to borrowers because it allowed borrowers to maintain a fixed rate and withdraw the maximum amount of proceeds at loan closing. The HECM Saver allows the borrower to continue to have the predictability of a fixed-rate with lower upfront costs, but the borrower is not able to draw as much funds as the Fixed Rate Standard.

MBA continues to support the HECM program and the association applauds FHA for devising a solution to immediately address problems with the HECM program but still allow seniors to have viable reverse mortgage options. As the population ages and seniors recover from the recent economic downturn, HECMs are an important option for this population. Although only a few years old, the HECM Saver is proving to be cost effective for borrowers and financially prudent for FHA. FHA is appropriately continuing to develop ways to better manage the program and ensure its sustainability, such as how to deal with taxes and insurance defaults. As Congress considers legislative action to improve the HECM program, we would urge you to consider the ramifications of restricting the program to such a degree that it will not serve its purpose of providing financial options to this important, and growing, population.

²¹ U.S. Dept. of Housing and Urban Development, Annual Report to Congress Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund (November 2012) at p. 50. Can be accessed at: <http://portal.hud.gov/hudportal/documents/huddoc?id=F12MMIFundRepCong111612.pdf>

²² Mortgagee Letter 2013-01.

Potential Impact on FHA from other Regulatory Initiatives

Potential changes to FHA cannot be viewed in a vacuum. Over the last five years, following the mortgage crisis, a host of major rules are in the process of changing the face of mortgage finance. Many of these changes are welcome and overdue, while others are concerning. All will permeate the financial system and FHA. And as these changes come on line, their impacts must be carefully assessed through the prism of how they will serve consumers and the nation. Three major rules deserve particular attention.

FHA Qualified Mortgage

The Dodd-Frank Wall Street Reform and Consumer Protection Act required the Consumer Financial Protection Bureau (CFPB) to issue rules implementing the law's "Ability to Repay" provisions and defining a class of "qualified mortgages" (QM) that would receive enhanced legal protection from lawsuits. The law further authorizes HUD, the U.S. Department of Veterans Affairs, and the U.S. Department of Agriculture, in consultation with the CFPB, to prescribe rules defining types of loans they insure, guarantee or administer that are QM loans, which may revise, add to, or subtract from the CFPB's definition. FHA loans comprise approximately 30 percent of today's mortgage market. For several reasons, MBA has strongly urged the CFPB to eliminate the distinction between FHA QM safe harbor and FHA QM rebuttable presumption loans or at least raise the APR threshold to better define FHA QM safe harbor loans.

The CFPB's final rule makes clear that the bifurcation between QM safe harbor loans and QM rebuttable presumption loans is intended to provide greater recourse to subprime borrowers. FHA loans, however, are not "subprime." They are subject to government oversight and significant regulation. FHA loans are generally fixed rate and adjustable loans are subject to extremely tight adjustment limits to protect borrowers. All loans must be fully-documented, meet minimum downpayment and other requirements, and loans with credit scores under 620 now must also meet DTI requirements. Given the parameters of the FHA program and its regulation of all aspects of the process, MBA believes its borrowers are already well protected. Establishing a cutoff for FHA safe harbor loans will only add regulatory burden without providing any offsetting benefit.

MBA strongly believes that for the foreseeable future lenders will be extremely wary of originating loans that fall outside of the QM safe harbor. Consequently, if the threshold is not at least expanded, the availability of FHA credit for underserved populations – first-time, minority, and low- and moderate-income borrowers – may be unduly limited, jeopardizing FHA's ability to fulfill its important role.

Qualified Residential Mortgage

Another outstanding issue that will have a profound impact on FHA is the proposed risk retention rule. The Dodd-Frank Wall Street Reform and Consumer Protection Act requires mortgage securitizers to retain five percent of the credit risk unless the mortgage is a Qualified Residential Mortgage (QRM). The proposed rule issued by six federal regulators nearly 18 months ago would require families to make a 20 percent downpayment and meet relatively low DTI and other stringent requirements. It is not at all clear from the proposal whether the regulators reflected on the relationship between the proposed QRM definition and the FHA's eligibility requirements in light of FHA's statutory exemption from risk retention. The proposed QRM definition appears to conflict directly with the Administration's plan for reforming the housing finance system because it would make it far more difficult for private capital to re-enter

the housing finance market. In its white paper, the administration made clear that it intends to shrink FHA from its current role of financing one-third of all mortgages, and one-half of all purchase mortgages.

MBA supports FHA's role as a source of financing for first-time homebuyers and other underserved groups. However, because of the wide disparity between FHA's downpayment requirement of 3.5 percent and the QRM requirement of 20 percent, MBA believes the proposed risk retention rule would force over-utilization of FHA and other government programs. While FHA should continue to play a critical role in our housing finance system, MBA firmly believes that it is not in the public interest for a government insurance program like FHA to dominate the market, especially if private capital is ready and willing to provide reasonable financing for the same borrowers.

Conclusion

MBA believes the recent changes announced by FHA are fiscally prudent and warranted given the financial realities described in the Actuarial Review of FHA's MMI Fund for Fiscal Year 2012. MBA also understands that over this next year, examining the potential and need for any further legislative FHA reforms will be a top priority for the Congress, HUD, and other policymakers as you consider various balanced options intended to help FHA maintain its mission focus and remain fiscally sound over the long term.

As that discussion intensifies, MBA stands ready to work with this committee as a resource to ensure that the trade-offs associated with these options are fully recognized, appreciated, and seriously considered during any subsequent legislative debate.