WRITTEN TESTIMONY OF SECRETARY SHAUN DONOVAN
HEARING BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES
FY09 FHA ACTUARIAL REPORT
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Thank you, Chairman Frank and Ranking Member Bachus for this opportunity to testify on behalf of the Administration regarding the Federal Housing Administration and the steps we are taking to protect its loan portfolio as it helps to get the economy back on track at this historic moment. As you well know, the fiscal health of the FHA is essential to its effective operation. We want to ensure that we are able to continue to support the housing market in the short-term and provide access to homeownership over the long-term, while minimizing the risk to the American taxpayer.

On September 18th, we announced an initial round of policy changes to reduce risk in the FHA portfolio. With the clearer picture provided by the recent study conducted by a non-governmental independent actuary, I want to announce here today that we will be implementing additional measures that we believe will further reduce the risk to the FHA portfolio. In these measures we will be focusing primarily on three areas: enforcement, improving the quality and sustainability of new loans insured by FHA, and increasing FHA capital. I will talk a bit more about these steps later in my testimony, but first I would like to say a few words about the role that FHA is playing in the market right now, the results of the actuarial study and the reforms we've put in place thus far.

FHA: Facilitating Recovery

Created by President Franklin Roosevelt at a time when two million construction workers were out of work and housing prices had collapsed, the FHA was designed to provide affordable homeownership options to underserved American families and keep our mortgage markets afloat during tough times.

And by insuring almost 30 percent of purchases and 20 percent of refinances in the housing market, FHA is certainly doing so today.

Though I would caution that we are by no means out of the woods yet, as the National Association of Realtors reported last week, home sales have rebounded to levels not seen since February of 2007. And the S&P/Case-Shiller Home Price

Indices finds that home prices have now risen for two quarters in a row.

While there is considerable uncertainty about what these numbers mean going forward, particularly as we enter the typically-slow winter months, what is not in doubt is that the FHA has been central to much of this improvement. We know the critical role first-time homebuyers are playing in the market, including purchasing REO and vacant properties, helping stabilize home prices and communities alike. More than three-quarters of FHA's purchase-loan borrowers in 2009 are first-time homebuyers, and nearly half of all first-time buyers in the housing market in the second quarter of this year used FHA loans.

And with 51 percent of African Americans homebuyers and 45 percent of Hispanic families who purchased homes last year using FHA financing, FHA is far and away the leader in helping minorities purchase homes.

Actuarial Study

Unfortunately, FHA has not been immune to the hard times for the housing sector. With the actuarial study I cited earlier, we recently reported to Congress that FHA's secondary reserves have fallen below the required two percent level – to 0.53 percent of the total insurance-in-force. However, when combined with reserves held in the Financing Account, FHA holds more than 4.5 percent of total insurance-in-force in reserves today – $31 billion set aside specifically to cover losses over the next 30 years.

As such, the actuary concluded that FHA's reserves will remain positive under all but highly severe economic scenarios.

Further, while its secondary reserve account has been depleted too quickly, FHA is not "the next subprime" as some have suggested.

Subprime delinquencies are 240 percent higher than FHA's for a reason. While others participated in investor-owned markets or were exposed to exotic mortgages such as option-ARMs and interest-only loans, and while some tolerated lax underwriting standards, FHA stuck to the basics during the housing boom: 30-year, fixed rate traditional loan products with standard underwriting requirements. Unlike subprime lenders, FHA requires that borrowers demonstrate they can pay their mortgage by verifying their income and employment.

All of that said, Mr. Chairman, we've learned from recent history that the market is fragile, and we have to plan for the unexpected. That uncertainty is complicated by an organization we inherited that, to be honest, was simply not properly managing or monitoring its risk.

Credit and risk controls were antiquated. Enforcement was weak. And our personnel resources and IT systems were inadequate.

Little of this may have been obvious when FHA's market share was 3 percent as recently as 2006. But when our mortgage markets collapsed last fall, and homebuyers increasingly turned to the FHA for help, the potential consequences of these lapses in risk management became very clear.

Reforms to Date

In 2008, Congress put an end to the practices that led to the most troubled loans in FHA's portfolio – so-called "Seller-Financed Downpayment Assistance" loans. Without these loans, I would note, the actuary reported that our secondary reserves would have remained above the two percent threshold.

This year, we've taken several additional steps. We've steeply increased enforcement efforts, having suspended seven lenders, including Taylor, Bean and Whitaker and withdrawn FHA-approval for 270 others, including Lend America just this week.

We've strengthened credit and risk controls – toughening requirements on our Streamlined Refinance program, making several improvements to the appraisal process and proposing a rule to increase net worth requirements for all FHA lenders. The latter has just entered the notice and comment period.

And we've hired a permanent Chief Risk Officer to provide the most comprehensive and thorough risk assessment in the organization's history – and ensure that the assumptions going into our modeling reflect the most current economic conditions.

In addition, with Congress' help, we are working to increase staffing and technical capacity and upgrade our technology systems – and though we still have a long way to go, we delivered FHA's first comprehensive technology transformation plan to Congress in September.

As significant as these reforms are, Mr. Chairman, as Senator Bond recently wrote in the *Washington Post*, these management and resource challenges are long-standing – challenges that could and should have been addressed a long time ago.

<u>Next Steps</u>

That is why we are drafting several new policies in FHA to address the quality of the existing portfolio, improve the performance of future books, and return the capital reserve to above the legislated 2 percent level, while also ensuring that FHA continues to contribute to the nation's housing recovery.

The actuary projects that even with growing volumes, more than 71 percent of FHA's losses over the next 5 years will come from loans already on our existing books. That's why an important step we can take to minimize losses to capital reserves in the near term is to step up enforcement and make lenders more accountable.

As such, the first set of policy changes we are proposing will focus on enforcement and lender accountability. We will step up efforts to ensure lenders assume responsibility for any losses associated with loans not underwritten to FHA standards.

We will hold lenders accountable for their origination quality and compliance with FHA policies, increasing our review of mortgagee compliance with FHA program requirements.

And we intend to expand enforcement for new loans as well. That includes requiring lenders to indemnify the FHA fund for their own failures to meet FHA requirements, and holding lenders accountable nationally for any improper activities, as we are presently limited to sanctioning individual branches.

We will also develop a Lender Scorecard that will summarize the performance of lenders who do business with the FHA. This scorecard will be posted on our website to ensure transparency and accountability for lenders, borrowers and the market.

Of course, all these steps are designed to hold lenders accountable for their origination quality and compliance with FHA policies. And as always, Ginnie Mae securities that are backed by FHA-guaranteed loans will continue to be fully covered by the full faith and credit of the U.S. government.

In addition to stepping up enforcement and accountability, which will improve the performance of both the existing and future books of business, we are committed to a series of additional steps to increase the quality of our business going forward.

An initial measure is to reduce the maximum permissible seller concession from its current 6 percent level to 3 percent, which is in line with industry norms, and we will continue to consider additional reductions. The current level exposes the FHA to excess risk by creating incentives to inflate appraised value.

Secondly, to protect the fund from the riskiest borrowers, we will for the time being also raise the minimum FICO score for new FHA borrowers.

We are currently analyzing what this floor should be, including the relationship between FICO scores and downpayments to determine whether we should increase FICO minimums in combination with changes to other underwriting criteria for lower downpayment loans.

Third, we have made the decision to exercise our authority to increase the up-front cash that a borrower has to bring to the table in an FHA-backed loan – to make sure that FHA borrowers have more “skin in the game” and a stronger equity position in their loans. There are several ways to accomplish this, and so we are currently analyzing various options to determine which is the most effective and consistent with our mission.

Finally, we are examining our mortgage insurance premium structure to determine whether an increase is needed and, if so, whether it should be the up-front premium, the annual premium or both. Our current up-front premium of 1.75 percent is below the statutory cap of 3 percent, while the annual premium is currently at the statutory maximum. To protect against future uncertainty in market conditions, we are requesting authority from Congress to raise annual premiums, as this is one of the most effective means of raising capital for the fund with the least impact per borrower.

Indeed, while most of these changes I've just described we can make on our own with no additional authority—and we expect to provide detail and public guidance for these changes by the end of January—in some cases, we will need Congress' help. In addition to asking Congress to increase the current cap on the annual mortgage insurance premium for new borrowers, we are asking for additional authority for our proposals to hold all FHA lenders responsible for their fraud or misrepresentations by indemnifying the FHA fund. We will also be asking Congress to expand FHA's ability to hold lenders accountable nationally for their performance as I mentioned earlier.

Each will require statutory support, and of course, we look forward to working with Congress closely on all these issues.

Facilitating our Recovery, But Protecting the Taxpayer

Mr. Chairman, Ranking Member Bachus, shoring up the FHA won't solve all our housing challenges – one reason the Administration is working to produce a more balanced, comprehensive national housing policy that supports homeownership and rental housing alike, providing people with the options they need to make good choices for their families.

Further, as important as the FHA is at this moment, I want to emphasize that the elevated role it is playing is temporary – a bridge to economic recovery helping to ensure that mortgage finance remains available until private capital returns.

That means that while we must remain mindful that qualified, responsible families need the continued ability to purchase a home, the changes I have announced today and those we will detail in the coming weeks will be crafted to ensure FHA steps back and facilitate the return of the private sector as soon as possible. Until the private sector can step back up, they need the FHA – and so does our housing market.

So, Mr. Chairman, while FHA must remain a key source of safe mortgage financing at a critical moment in our country's history, we recognize the risks that we face and the challenges of this temporary role that we play in today's market. And the bottom line is this: the loans FHA insures must be safe and self-sustaining for the taxpayer over the long-term. With these reforms and others we will be considering, the Administration is committed to ensuring that they are today – and into the future.

Thank you.