MORTGAGE BANKERS ASSOCIATION
Investing in communities

Testimony of Robert E. Story, Jr., CMB

Chairman

Mortgage Bankers Association

Before the

House Committee on Financial Services

Hearing on

"The Federal Housing Administration's Fiscal Year 2009 Actuarial Report"

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Chairman Frank, Ranking Member Bachus and members of the committee, thank you for the opportunity to testify on behalf of the Mortgage Bankers Association (MBA)[1] on the Federal Housing Administration's (FHA) Fiscal Year 2009 Actuarial Report ("Actuarial Report"). I am Robert Story, Jr., President and Chief Executive Officer of Seattle Financial Group, and the Chairman of MBA.

FHA is especially important to segments of the population who need a little extra help to achieve the American dream of homeownership. More than any other nationally available program, FHA focuses on the needs of first-time, minority, and low- and moderate-income borrowers. According to recent data provided by the Department of Housing and Urban Development (HUD), both first-time homebuyers and minorities continue to make up a significant portion of FHA's customer base. As of August 2009, approximately 78 percent of FHA-insured home purchase loans were made to first-time homebuyers, and 30 percent were made to minorities. Minorities also comprise a higher percentage of the FHA market than the conventional mortgage market.

MBA has always been a proponent for a strong and vibrant FHA. We called for updates and enhancements to FHA's risk management, scope and operations well before the current market disruptions reestablished FHA's prominence as a catalyst for bringing liquidity to the housing finance system. With the increased growth of FHA and the need to protect the Mutual Mortgage Insurance Fund ("MMI Fund"), it is imperative that we move swiftly and take appropriate measures now to protect the safety and soundness of the agency. Protecting and improving FHA requires a multifaceted approach: ensuring that FHA has the right resources; requiring high eligibility standards for lenders; creating credit policies that are both prudent and aligned with FHA's mission; and ensuring that FHA is helping to provide market liquidity during times of crisis. In support of these goals, we recommend measures such as raising net worth requirements for FHA-approved lenders, reevaluating credit and underwriting standards, reexamining the insurance premium structure, and establishing sensible consumer and lender protections for Home Equity Conversion Mortgages (HECM). MBA believes these actions will not only help FHA face current market challenges, but also ensure the agency's future viability.

MBA wants to take this opportunity to thank the committee for its support of two very important policies that will help FHA continue to provide market liquidity and bring back the housing market: extending the higher FHA loan limits and extending and expanding the homebuyer tax credit. Currently, FHA, Ginnie Mae and the GSEs are the only

[1]The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,400 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

significant sources of housing finance liquidity. It is imperative that these entities provide secondary market support to as broad a spectrum of homes as possible during this period of market instability and beyond. The homebuyer tax credit, along with lower mortgage interest rates, has helped to moderate the decline in home prices by stimulating demand. With the expansion of the credit to include more borrowers, we believe this initiative will have an even greater impact on the housing market.

On November 12, 2009, FHA released the Actuarial Report. The report showed that the capital reserve account of the MMI Fund had fallen well below the two percent statutory target. In fact, it had fallen dramatically from three percent in 2008 to 0.53 percent in 2009. The announced shortfall in the capital reserve account was a major wake-up call for FHA and the lending community but not a reason to panic. The two percent target was established by Congress in order to ensure that FHA could stand the stress of a major housing and mortgage market event, an event like the one the industry is facing today. Despite the drop in the reserve account, HUD leadership has stated that FHA will not need taxpayer assistance to continue to operate.

The significant drop in the MMI Fund does, however, add urgency to MBA's efforts to evaluate and make recommendations to strengthen risk-management at FHA. Now is the time to make reasonable management decisions to protect the MMI Fund, while allowing FHA to continue to support the housing market. FHA's volume historically has been countercyclical: when the private market is under stress, FHA's volume increases as a way to fill the void, as is happening today. MBA applauds Commissioner Stevens' recent efforts to improve FHA's risk management, including hiring a Chief Risk Officer and reevaluating a number of existing polices.

However, we know that the agency will need to take further action to bring capital reserves promptly back to the two percent level. There are several options to protect the MMI Fund, including moving to a risk-based premium structure, increasing the upfront insurance premium, tightening credit guidelines, or a combination of these approaches. There are clearly pros and cons to each option, and, depending on the details, MBA is open to supporting any of these options or a combination thereof.

An example of the association's commitment to FHA is the creation of the MBA Council on the Future of FHA. This executive-level task force, comprised of lenders from small and large companies, is dedicated to assessing policy options for both singlefamily and multi-family programs and to making recommendations on how best to sustain FHA. Our short-term recommendations will focus on protecting the MMI Fund and helping the agency through this market crisis, while our long-term recommendations will focus on how to use this crisis as an opportunity to make meaningful structural changes to FHA that will permanently improve its programs. We look forward to sharing these recommendations with you in the coming months.

<u>FY 2009 FHA Actuarial Report</u>

The Actuarial Report provides an assessment of the fiscal health of FHA and its financial outlook. These reports provide a snapshot of the FHA portfolio at a particular point in time, which in this case was September 30, 2009. As expected, the capital reserve ratio of the MMI Fund has dropped below the minimum target of two percent. Given that the country just went through one of its greatest recessions, it is not surprising that FHA loans, and every other type of loan, are becoming delinquent and entering foreclosure at higher rates, as the unemployment rate continues to rise. Clearly, macroeconomic factors are weighing heavily on the defaults of the MMI Fund. The country's high unemployment rate, a significant depreciation in house values, and increased foreclosures are affecting many sectors of this economy.

Highlights of the Actuarial Report include:

- The capital reserve ratio as of September 30, 2009, was at 0.53 percent. In 2008, the ratio was three percent. The capital reserve ratio measures *excess* reserves beyond forecasted net claim costs on outstanding loans.

- The combined FHA capital reserve and finance accounts equal $31 billion in total reserves, or about 4.5 percent of the agency's total insurance-in-force.

- During the last fiscal year, FHA guaranteed more than $360 billion in single-family mortgages, a 75 percent increase over FY 2008 activity.

- Under most economic scenarios, FHA's total reserves remain above zero. A key factor to how quickly reserves will grow is the stability of home prices.

- The MMI Fund is greatly impacted by the performance of seller-funded downpayment assistance loans. Claim rates for these loans are two to three times higher than other FHA loans. An additional $10.4 billion in losses is expected to occur as a result of these loans. It should be noted that, according to the Actuarial Report, FHA would have achieved the two percent capital ratio if seller-funded downpayment assistance loans were excluded from the audit. Congress prohibited these types of loans in 2008 through the passage of the Housing and Economic Recovery Act of 2008 (HERA).

<u>Recent Changes in FHA Borrowers and FHA's Book of Business</u>

MBA has reviewed the audits of the HECM and non-HECM portions of the MMI Fund. These audits used a wealth of data, sophisticated use of industry standard modeling techniques, and reasonable assumptions regarding potential economic environments that could impact the capital adequacy of the MMI Fund. Clearly, different choices of model specifications or economic assumptions might have led to somewhat different results, but these audits appear to have been conducted carefully and professionally, and hence are a valid basis for the important public policy discussion regarding FHA in which we are now engaged.

For a private sector financial institution, regulatory capital measures are a key measure 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 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 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.

The Actuarial Report raises a number of MMI Fund performance issues of concern to MBA. These concerns underscore the need for increased risk management at FHA. A summary of these concerns is below:

- Industry standard models predict that the FHA combination of low downpayments and lower credit scores could lead to default rates that are significantly higher than loans with higher downpayments and better credit. Because of this projection, we believe a reexamination of FHA's minimum borrower credit requirements is warranted.

- At any time, it is difficult to accurately estimate expected credit losses on a portfolio. It is particularly difficult to estimate expected credit losses on the FHA portfolio (given its relatively high level of risk) under these market conditions. For that reason, we encourage FHA to make immediate programmatic changes that would replenish the capital reserve account to cover potentially large unexpected losses, without compromising the agency's mission.

- As FHA has entered new segments of the market, particularly expanding the share of its business in certain geographic areas, the uncertainty regarding these estimates increases. The average FHA loan size is less than $200,000, but FHA is making loans up to $729,750 in high-cost areas. Even though many of these loans are to higher credit score borrowers, there is the potential for much larger losses due to higher balance loans.

- Conventional-to-FHA refinances are a major source of the new business from high-cost markets. The impact is a better credit profile, but such refinances introduce new risks as these are areas of the country where FHA has limited history.

- The seller-funded downpayment assistance program is clearly responsible for a large portion of the expected losses on the current book. Fortunately, Congress ended this program in 2008, but this situation underscores why FHA needs the flexibility to make quick, independent programmatic adjustments in response to market changes or to problems within a program. Additionally, FHA, Congress, and the industry need to carefully evaluate FHA's current risk posture to prevent similar programs from consuming such a disproportionate share of resources in the future.

- Some of FHA's underwriting criteria raise concerns. From January through August 2009, 86 percent of FHA purchase loans had loan-to-value (LTV) ratios of 96 or higher. Approximately 87 percent of FHA refinance loans had LTV ratios above 80. FHA loans also are underwritten to higher ratios than conventional loans. While conventional loans typically are limited to front-end (mortgage payment/income) ratios of 28 percent and back-end (total debt/income) ratios of 36 percent, FHA ratios allow borrowers to have ratios of 29 and 41 percent respectively. Again, the quality of FHA originations has improved in recent years, primarily due to the inflow of borrowers who do not have other financing options.

While we have the concerns listed above about the MMI Fund, we should also note several features of FHA lending that mitigate risks and may help improve future performance. FHA's loan volume has soared in recent years – increasing from approximately three percent of the market in 2006 to approximately 30 percent in 2009 – due to the contraction of the private market. With this increase has come a change in FHA portfolio composition. Changes in borrower and loan profiles and geographic distribution have played significant factors in what the FHA book of business looks like now and how we can expect it to perform in the upcoming years. Highlights of these trends are noted below:

- The quality of FHA originations has improved in recent years, primarily due to the inflow of borrowers who do not have other financing options. In FY 2009, 44 percent of FHA loans had credit scores above 680, compared to just 25 percent in FY 2008 and 19 percent in FY 2007. In 2009, the average credit score of new borrowers reached 690. Additionally, 30 percent of the FY 2009 loans had credit scores above 720, compared to 16 percent in FY 2008 and ten percent in FY 2007. Importantly, there has been a decline in the percentage of credit scores below 620. In FY 2009, 13 percent of FHA loans had credit scores below 620, versus 34 percent in 2008 and 47 percent in FY 2007. These statistics show that although FHA volume is increasing, borrower credit is improving.

- FHA's adjustable rate mortgage (ARM) share has always been quite low: typically only one to two percent. Fixed-rate loans tend to have lower default risk than ARMs. FHA also requires full documentation on the majority of its loans. (The exception is its streamlined refinance program, which refinances a borrower from one FHA loan to another. It should be noted that FHA recently tightened the guidelines for this program in an effort to better manage risk). This requirement substantially reduces credit risk. Standard and Poor's estimates that credit losses on no doc loans average six times higher than those on full doc loans.

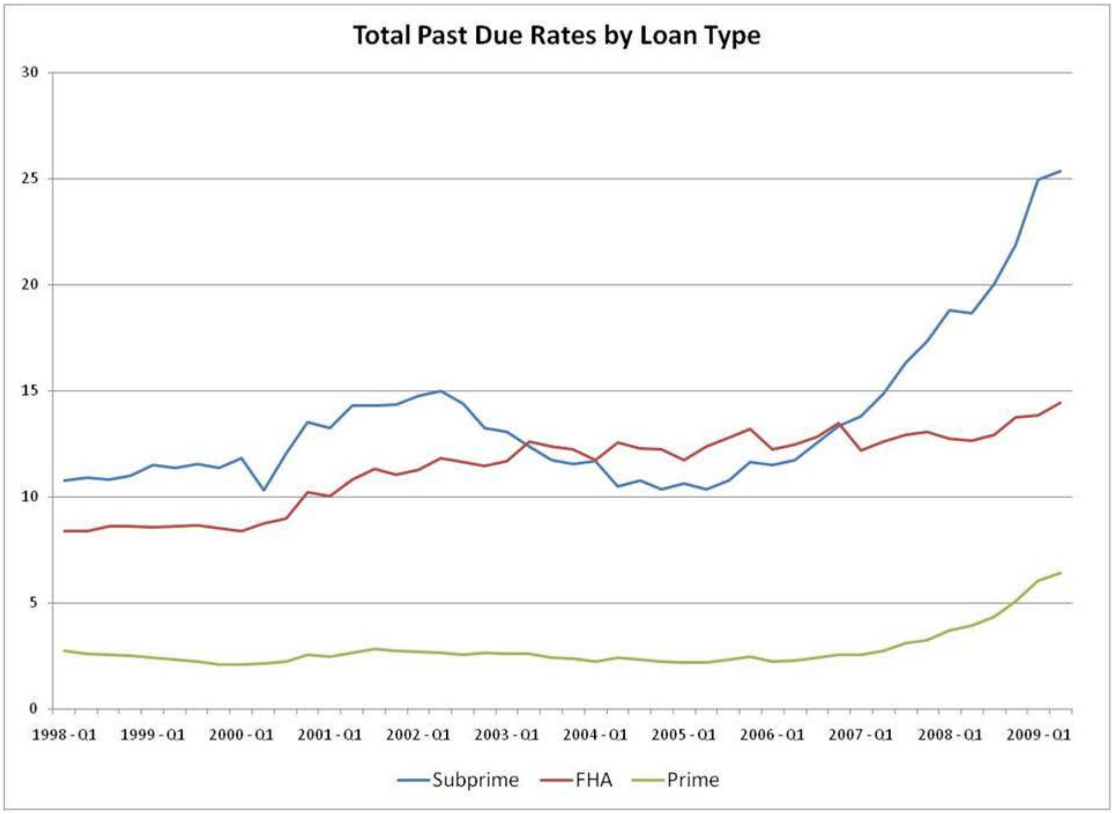
- The influx of new business also has altered the geographical composition of the FHA portfolio in several notable respects. FHA has typically had a much larger presence in lower cost markets across the country, particularly in Midwestern and Southern states. Until recently, FHA played a very small role in the higher cost coastal states. For example, FHA used to do just two percent of its business in California. This year, it is doing 12 percent. This geographical distribution has helped FHA weather the current economic storm because it insured so few loans in some of the locations that have been plagued by a high foreclosure rate due to overbuilding and a severe decline in home values.

- Despite this new business, FHA remains an extremely important source of financing for first-time homebuyers. First-time homebuyers have accounted for 76 to almost 80 percent of all FHA purchase applications in the past two years. By comparison, in the broader market, first-time buyers typically account for about 40 percent of home purchases.

- FHA has also always been an important source of financing for minority home buyers. Minorities account for approximately 25 percent of FHA purchase loans and about 30 percent of FHA first-time home buyer loans. These shares have decreased slightly in the past two years as more non-minority borrowers have turned to FHA.

- FHA refinance business has also increased, thus helping existing borrowers lower their monthly mortgage payment and bringing new borrowers to FHA. In FY 2009, FHA insured approximately 20 percent of total refinances in the housing market. Access to FHA financing has substantially helped borrowers seeking to refinance into what are historically low mortgage rates. In fact, not only have homeowners with FHA loans been able to refinance, but, in many months, a larger number of homeowners with conventional loans have been able to refinance through FHA. For these homeowners, lower monthly payments are a tremendous benefit during difficult economic times.

<u>MBA's National Delinquency Survey</u>
Given this profile of FHA business, particularly the mix of risk characteristics, one would expect FHA loans to have higher delinquency and foreclosure rates than prime loans, but lower than subprime loans. In fact, that is what the historical data from MBA's National Delinquency Survey (NDS) has shown, with some important exceptions.



As shown in the chart above, from 1998 through 2002, total past due rates on FHA loans tended to track between those on prime and subprime loans. From 2003 to 2007, delinquency rates on FHA loans were actually higher than those on subprime loans, but this was primarily due to FHA's declining market share – a shrinking denominator increased the reported delinquency rate. From 2007 to the present, the opposite is at work. FHA's book is growing rapidly – the number of FHA loans outstanding has increased by about 1.1 million over the last year – and as a result the denominator is growing faster than delinquencies are rising, pushing down the reported delinquency rate. Similar dynamics are operating with respect to FHA's foreclosure rate.

According to MBA's Q3 2009 NDS, the delinquency rate for FHA loans increased 134 basis points this quarter (from 13.70 percent to 15.04 percent), and has increased 144 basis points relative to last year. FHA's foreclosure starts rate increased 16 basis points this quarter (from 1.15 percent to 1.31 percent), and has increased 36 basis points over the past year. The foreclosure rate on FHA loans increased, despite having a large increase in the number of FHA-insured loans outstanding. If we assume these newly-originated loans are not the ones defaulting and remove the big denominator increase from the calculation results, the foreclosure rate would be 1.76 percent rather than 1.31 percent reported.

An analysis of the Actuarial Report and NDS indicates that there are significant risks in the MMI Fund, but there also are encouraging signs that point to a promising FHA future. MBA would like to reiterate its support for various programs and policies that we believe are crucial to the long-term sustainability of FHA and the housing market.

Resources Necessary for Improved FHA Operations

MBA believes a critical requirement for achieving, sustaining and protecting the housing market's long-term vigor is ensuring that FHA has the resources it needs to operate in a modern, high-tech real estate finance industry. FHA's staff levels have remained virtually unchanged, even though its market share has risen from three to over 30 percent. This ratio of activity to resources is unsustainable because it stretches FHA beyond its capacity. MBA strongly supports H.R. 3146, the 21st Century FHA Housing Act, which would provide FHA with up to $72 million in funding to hire additional staff and upgrade compensation to be commensurate with that of other federal financial regulators. The bill also permits funding to upgrade technology. Modern technology would enable FHA to better monitor lenders, protect against fraud, and generally be better equipped to handle the challenges of a modern marketplace.

MBA is grateful that, in HERA, Congress authorized $25 million to be allocated each year from FY 2009 through 2013 to provide FHA with improved technology and processes and to help reduce mortgage fraud. The Omnibus Appropriations Act of 2009[2] made $4 million available for FY 2009 and FY 2010 to be used "for planning, modernizing, improving and maintaining information technology applications and infrastructure supporting FHA." While this funding is appreciated, it is not nearly enough to address FHA's growing needs. We urge Congress to provide the full $25 million each fiscal year though 2013, as authorized under HERA. Furthermore, as in H.R. 3146, FHA should be given the statutory authority to use its future revenues to make technology upgrades as needed. Ensuring these resources are available to FHA not only helps support the viability of its products and services, but it also helps protect the MMI Fund and the American taxpayer.

Recent FHA Credit Policy Changes

Given the growth in its market share, and the potential risk to its finances, it was prudent for Commissioner Stevens to make recent policy changes to the FHA program. MBA supports the direction of these changes and expects to work closely with FHA to implement additional adjustments that will help put the agency on a stronger financial footing.

Appraisals

As MBA stated in previous testimony, reliable and accurate collateral valuations are important tools to help FHA, lenders, and investors estimate their risk of loss in a home purchase or refinance transaction. Determining a property's value is not an exact science, and it is even more difficult in markets where home prices are volatile or declining. As a method of promoting reliable and accurate appraisal practices, FHA-

[2] Pub. L. 111-8 (March 10, 2009).

approved lenders are required to use certified appraisers listed on FHA's Appraiser Roster.

MBA members continue to express concern regarding the ambiguity of various terms of the Fannie Mae and Freddie Mac (the GSEs) Home Valuation Code of Conduct (HVCC), and we have undertaken several initiatives to obtain clarifying interpretations from the drafting parties: the GSEs, Federal Housing Finance Agency and New York Attorney General. We understand the guidance recently issued by FHA was an attempt to refine several of the more contentious HVCC terms, such as permissible communications with appraisers and appraisal portability. MBA appreciates FHA's proactive attempt to add the agency's perspective in these areas. We also recognize that the HVCC is just one component of the supervisory framework governing appraisal practices, which also includes the Uniform Standards of Professional Appraisal Practices (USPAP) and other interagency guidance of the federal financial institution regulators. We are committed to working with all of these regulatory bodies to ensure that property valuations are reliably prepared by qualified professionals in an environment free from coercion.

Revised Streamline Refinance Transactions

FHA's refinance transactions are meant to allow borrowers to pay off an existing loan and refinance into one that offers a better financial option. Recently, some borrowers have been using streamline refinances as a loss mitigation tool, which is an improper use of the product. MBA supports the direction of the changes that FHA made to its streamline refinance program. Verifying documentation, determining net tangible benefit, and obtaining credit scores, when available, are all sound underwriting practices that MBA supports.

Net Worth Requirements and Modification of Mortgagee Approval Process

As a government housing finance program, FHA deserves, and borrowers should expect, exceptional quality standards. FHA-approved lenders and correspondents (mortgage brokers) should be held to the highest levels of accountability, knowledge and professionalism. For these reasons, MBA recommends raising FHA's existing qualification standards.

One area where FHA should consider enhancing its quality controls is by setting higher net worth and bonding requirements for single-family mortgage correspondents and bankers to participate in the program. Such net worth requirements would better hold lenders and correspondents accountable for their actions.

FHA also is proposing to modify the mortgagee approval process, thus eliminating the requirement for loan correspondents to receive independent FHA approval for origination eligibility. The FHA-approved mortgagee would then assume the responsibility and liability for the loans underwritten and closed by the broker.

According to FHA, this policy change is necessary because the agency does not have the resources to effectively manage and monitor the broker community. The shift in responsibility also aligns its policies with those of the GSEs. MBA agrees that FHA staff is stretched thin and requires additional resources to develop and implement quality control mechanisms and we are considering FHA's proposal, as well as other suggestions. Regardless of whether we ultimately support the proposed approval process, MBA believes FHA should establish a minimum net worth requirement for brokers because it is important to have a uniform standard to promote consistent quality and a level playing field.

As both of these changes must be done through the rulemaking process, MBA will provide extensive comments once the details of HUD's proposal are known.

Home Equity Conversion Mortgage Program

Home Equity Conversion Mortgages are designed to help one of our most vulnerable populations, seniors, so it is critical that care be taken to prevent abuses. In an effort to be proactive in this area, MBA convened an executive-level task force last year that created a reverse mortgage model bill for states. This model bill would protect both consumers and lenders and would offer a unified approach to these policies across states. Most of our recommendations were modeled after FHA's existing HECM policies. MBA is firm in its support for mandatory counseling for all reverse mortgage borrowers, as well as preventing cross-selling as a condition for receiving a reverse mortgage.

This year, for the first time, FHA requested a subsidy of $798 million as part of the President's FY 2010 budget, to cover losses that might be incurred over the life of the loans originated in FY 2010. The House version of the appropriations bill did not include any subsidy, while the Senate version included a subsidy of $288 million. These two bills are currently in conference. In the meantime, it became clear that FHA needed to re-evaluate the HECM program. This evaluation led to the recently-announced change to the principal limit factors that became effective October 1, 2009. This change resulted in a 10 percent reduction to the principal limit. Although MBA understands the business rationale for this change from a risk perspective, it is critical to note that it is the consumers who are being negatively impacted because they are receiving lower proceeds for the same cost. MBA also objects to the short implementation time for such a significant policy change.

Some of the other choices for addressing the HECM shortfall include Congress appropriating a subsidy, FHA changing the upfront premium, or FHA reducing the HECM loan limit. MBA does not support a reduction in the existing loan limit. We are working with FHA and other industry groups to recommend a long-term solution that would keep the HECM program self-sustaining.

FHA Multifamily Programs

With all of the focus on the residential real estate market, MBA must point out the continued – and even expanded – importance of FHA's multifamily programs in today's housing market.

During the current market downturn, affordable rental housing becomes a more urgent need for families and elderly individuals who either cannot afford to buy or who chose to rent. With the collapse of the commercial mortgage backed securities (CMBS) market, FHA is experiencing a significant increase in volume in its multifamily and healthcare programs. During FY 2008, FHA issued commitments for $3.4 billion in multifamily/healthcare mortgages. In FY 2009, FHA issued commitments for $5.1 billion, a more than 50 percent increase, and these numbers do not reflect substantial waiting lists for applications whose reviews were delayed into FY 2010 because of limited FHA staff capacity.

FHA's multifamily and healthcare programs are extremely staff-intensive, as each application must be thoroughly reviewed and approved by FHA staff prior to the issuance of a commitment. The need for additional staff and enhanced technology are as critical for these programs as they are for the single family programs.

MBA also wants to commend the House for passing H.R. 3527, the FHA Multifamily Loan Limit Adjustment Act, in September. While FHA's multifamily loan limits are sufficiently high in most markets, in some areas of the country they are severely restricting the ability to use FHA insurance programs to finance rental housing. H.R. 3527 will increase the loan limits for elevator buildings and provide the HUD Secretary with additional discretion in extremely high-cost areas (similar to that provided in Alaska and Hawaii today).

Conclusion

Thank you for the opportunity to testify. The U.S. and world economies are just beginning to recover from what has been one of the most severe economic downturns in 70 years. To some extent, it makes sense that both private and public institutions have depleted their capital resources during this period – this is the stress test. Nevertheless, it is important to take this time to prudently, but quickly, evaluate how to strengthen an agency like FHA's resources for the future. Hasty policy decisions could do more harm than good. MBA appreciates all that FHA is doing to provide stability, liquidity and affordability during this difficult time in the housing finance market – it is performing its countercyclical role as intended. MBA stands ready to work with Congress to enhance and sustain FHA now and in the future.