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"Implementation of Higher FHA Loan Fees and Pending Legislative Proposals to Strengthen the FHA MMIF Fund and Improve Lender Oversight"

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Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify today on the progress the Federal Housing Administration has made towards strengthening its financial condition.

As you know, last year we informed Congress of the independent actuary's findings that FHA's secondary reserves had fallen below the required level. Ten months later, while there is still much work to be done, FHA is on a predicted path that will put the agency in a stronger financial position for the future.

Mr. Chairman, last year at this time the independent actuaries predicted that we would draw down $2.6 billion of capital resources over the first three quarters of this year to pay for rising claim expenses. As noted in our third quarter MMI Fund report to Congress, instead of decreasing by $2.6 billion, net income increased by $450 million. Once we add interest earnings to core insurance income, our capital resources grew by $1.3 billion in the first three quarters of this fiscal year. While our actual performance to date has been significantly better than predicted by the actuary, the net budgetary actuals are in-line with projections in the President's Budget that was provided to the Congress in February.

While economic conditions evolve and significant risk and short-term house price volatility remain present, current trends indicate that as a result of the actions taken by the Administration and Congress, we are making progress in strengthening the FHA portfolio and rebuilding our capital reserves.

The positive signs we are seeing are due, in large part, to the numerous reforms put in place and actions the FHA has taken over the last year, including an increase to insurance premiums in April and the suspension or withdrawal of approval for 1,500 lenders from doing business with FHA. This does not yet account for the additional authority to change our annual premium structure passed by Congress that will add an estimated $300 million per month to the FHA fund.

Of course, we remain cautious, and the job is not yet done. With home prices uncertain, our continued vigilance in strengthening both loan quality and performance for future loans is particularly important. To that end, it is important to note that the early performance data of loans insured in FY 2009 and 2010 are much stronger than previous years. While FHA is currently playing an important and temporarily elevated role in providing liquidity to the housing market, it is doing so responsibly.

With the remainder of my testimony, I will explain our efforts in greater detail. In particular, I will describe the role FHA is playing in the market, the reforms FHA and the Congress have put in place, the early results these reforms are producing, and why our ability to protect the taxpayer for the future requires Congress to enact the broader, more comprehensive set of reforms we have proposed.

FHA's Current Role in the Housing Market

I'd like to take a moment to outline the important countercyclical role FHA has played in our housing market during these difficult economic times. Created by President Franklin Roosevelt in 1934 at a time when housing prices had collapsed, the FHA was designed to provide affordable homeownership options that would keep our mortgage markets afloat during tough times.

Indeed, when the market began its slow collapse three years ago, FHA comprised only about two-to-three percent of the housing market. But when private capital vanished at the end of 2008, it was the FHA that stepped in – insuring approximately 30 percent of purchases and 20 percent of refinances in the housing market. Since January 2009, the agency has helped nearly 3 million Americans either purchase a home, or refinance into more stable, affordable mortgages. At the same time FHA has also helped more than a half million families at risk of foreclosure through 760,000 loss mitigation actions.

The results of these extraordinary but necessary actions, combined with many others across the Administration, are clear. Home prices began to stabilize. And homeowner equity started growing again in the second quarter of 2009 – to date, increasing over a trillion dollars, or close to $14,000 on average for the nation's nearly 78 million homeowners.

FHA's Current Financial Condition

Still, this heightened role comes at a cost. Last November, upon the final completion of FHA's independent actuarial review of fiscal year 2009, we reported to Congress that FHA's secondary reserves had fallen below the required two percent level – to 0.53 percent of the total insurance-in-force. Combined with reserves held in the Financing Account, FHA reported that it held more than 4.5 percent of total insurance-in-force in reserves – $31 billion set aside specifically to cover losses over the next 30 years.

The Administration has taken very seriously its responsibility to ensure that FHA is operating on sound financial footing while minimizing risk to taxpayers. Since I took office as FHA Commissioner in July 2009, we have implemented a broad range of actions demonstrating steadfast stewardship of the fund, while carefully ensuring that we continue to serve communities nationwide.

Specifically, over the past year, this Administration has announced and implemented the most sweeping combination of reforms to FHA credit policy, risk management, lender enforcement, and consumer protections in its history. These reforms have strengthened our financial condition and minimized risk to taxpayers as we continue to fulfill our mission.

On behalf of Secretary Donovan and myself, I want to thank both chambers of Congress, and particularly the leadership of you, Chairman Frank, Ranking Member Bachus, Subcommittee Chairwoman Waters and Ranking Member Capito, for the partnership and cooperation exhibited in passing H.R. 5981, which provides FHA the authority to modernize its premium structure. As you know, this authority was granted through unanimous consent in the Senate and passed by voice vote in the House before being signed into law by President Obama on August 11, 2010. FHA has moved quickly to implement a new premium structure, which will take effect on October 4. Similar authority was included in H.R. 5072, the broader FHA reform measure, which this Committee passed in May and which passed the full House of Representatives in June. While the swift work of Congress has allowed us to implement the premium change, which is important for FHA's ability to generate greater revenues for taxpayers in line with the President's Fiscal Year 2011 Budget proposal, we at HUD remain committed to comprehensive FHA reform which will provide the tools we need to continue our efforts.

As you know, on January 20th of this year, FHA proposed taking a series of administrative steps to mitigate risk and augment the Mutual Mortgage Insurance (MMI) Fund's capital reserves. These proposals included: increasing the mortgage insurance premium (MIP); imposing a firm floor on allowable credit scores; requiring a higher down payment for borrowers with lower credit scores; further tightening the minimum credit score required for borrowers with low down payments; reducing the maximum permissible seller concession to match the industry norm; and implementing a series of significant measures aimed at increasing lender responsibility and enforcement. We have followed through with each of these reforms, which I will discuss in this testimony.

In conjunction with updated down payment and credit score guidelines published on September 3, the changes to FHA's premium structure are projected to result in an additional $4.1 billion in FHA receipts in Fiscal Year 2011.

With the 2010 fiscal year coming to a close, the independent actuary is in the process of completing its annual study and projections of the capital reserve ratio of the FHA MMI Fund. We expect to deliver the finding of this independent study to Congress in November, which will include the official measure of the capital reserve ratio.

In the interim, I am pleased to inform you that tangible, measureable progress is being made to improve loan quality and performance compared to past years. The independent actuary projected that more than 71 percent of FHA's losses over the next 5 years will come not from newly insured loans, but loans already on our existing books when this Administration took office.

Indeed, the early-period delinquency rates for FY 2009 and FY 2010 loans are much lower than the early-period delinquency rates for loans insured in FY 2007 and FY 2008. This improvement suggests that ultimate claim rates on loans endorsed in FY 2009 and FY 2010 should be markedly better than the ultimate claim rates of loans endorsed in FY 2007 and FY 2008.

As detailed in FHA's third quarter report to Congress, it was clear that FHA's loan characteristics and financial performance are better than had been forecast in the FY 2009 actuarial review.

Highlights of FY 2010 Q3 Report to Congress

On August 2, FHA delivered its third quarter report to Congress highlighting the status of the single family MMI Fund programs (enclosed in appendix). As mentioned above, FHA has conducted rigorous analytical reviews, established new reporting protocols and procedures, and announced some of the most extensive policy changes in its history. Under the supervision of our new Chief Risk Officer, these changes have been made to better protect the safety and soundness of the MMI Fund while continuing to serve our mission and support the stabilization of the housing market.

As part of our commitment to increased transparency and to provide Congress with better information and data on the performance and operations of the MMI Fund, we enhanced our quarterly report to include the financial status of MMI Fund cash flows, early payment delinquencies and serious delinquency rates.

As I noted earlier, the third quarter report shows that many aspects of the fund are in better shape. Specifically, the amount of cash reserves in the fund is nearly $3 billion higher than forecasted in last year’s actuarial report.

There are other positive signs as well. FHA’s portfolio shows the average credit score on current insurance endorsements has risen from 634 in 2007 to nearly 700 today. Loan performance, as measured by serious delinquency and early period delinquency rates, has improved significantly, with the first year-over-year decline in new 90-day delinquencies in years. And actual claim payments to date are $3.7 billion lower than had been projected by the independent actuary although this is somewhat offset by lower than projected property recoveries.

Additional Reforms – Progress to Date

The two key ways in which we have strengthened FHA fund solvency have been to increase revenues and engage in better risk management. Therefore, we have been focused on restructuring our mortgage insurance premiums and putting in place mechanisms and policies to protect the FHA for the future.

In October of 2009, we hired the first Chief Risk Officer in the organization’s history. On July 28, 2010 we received Congressional approval to formally establish this position and create a permanent risk management office within FHA, for which the Risk Officer is now Deputy Assistant Secretary. With this new office and additional staffing, we have begun to expand our capacity to assess financial and operational risk, perform more sophisticated data analysis, and respond to market developments.

Additionally, FHA introduced policy changes and improved lender oversight and enforcement to increase the quality of FHA insured loans. From my first day as FHA Commissioner, I began a thorough review of our loan practices and organizational capacity and gaps. Over the past 12 months we have introduced a number of new policies and taken several steps within our existing authority, all aimed at strengthening the quality of FHA-insured loans while focusing on ways to improve our operations.

In April, we published Final Rule (FR5356-F-02) "Federal Housing Administration: Continuation of FHA Reform – Strengthening Risk Management Through Responsible FHA-Approved Lenders." Most significantly, this rule eliminated FHA approval for loan correspondents and increased net worth requirements for lenders, thereby strengthening FHA's counterparty risk management capabilities.

On April 5 of this year, FHA raised its upfront mortgage insurance premium from 175 basis points to 225 basis points across all FHA product types (purchase, conventional to FHA refinances, and FHA to FHA refinances).

Subsequently, passage of H.R. 5981 granted us the authority to adjust the FHA annual premium. As stated in previous testimony and noted in the proposed budget, once this authority to adjust FHA's annual premium was granted, we would move to lower the upfront premium simultaneously with an increase to the annual premium.

Effective October 4, 2010, FHA will reduce upfront premiums from 225 basis points to 100 basis points and increase the annual premium to 85 basis points from 50 basis points for loans with loan-to-value ratios (LTV) up to and including 95% and to 90 basis points from 55 basis points for LTVs above 95%.

We are confident this new premium structure is sound policy, more in line with private mortgage insurers' pricing, and will facilitate the return of private capital to the mortgage market. In addition, the estimated value of this change is approximately $300 million per month of additional income to the MMI Fund.

Our Mortgagee Review Board, which I chair, meets monthly and has uncovered numerous violations of FHA origination and underwriting requirements. We have found false certifications and omissions, such as failures to verify the borrower's income and creditworthiness increased mortgagee review board actions. We've suspended some well-known FHA-approved lenders and withdrawn FHA-approval for over 1,500 others. In addition, we imposed over $4.27 million in civil money penalties and administrative payments to non-compliant lenders.

Beyond steeply increasing lender enforcement, we've strengthened credit and risk controls – toughening requirements on our Streamlined Refinance program, making several improvements to the appraisal process and to condominium policies, and publishing a final rule in the Federal Register outlining new down payment and credit score requirements.

Specifically, FHA implemented a "two-step" FICO floor for FHA purchase borrowers, which will reduce both the claim rate on new insurance as well as the loss rate experienced on those claims. A minimum down payment of 10% is now required of purchase borrowers with FICO scores below 579, and a minimum down payment of 3.5% is required for those with FICO scores at 580 and above. In addition, applicants with credit scores below 500 are no longer eligible for FHA insurance.

Currently, we have a proposed rule in the Federal Register which is in the comment period to reduce the maximum permissible seller concession from its current 6 percent level to 3 percent, which is in line with industry norms. The current level exposes the FHA to excess risk by creating incentives to inflate appraised value. FHA's experience shows that loans with high levels of seller concessions are significantly more likely to go to claim. Experience to date on loans insured from FY 2003 to FY 2008 suggests that claim rates on high-concession loans are 50 percent higher or more than those on low-concession loans. We anticipate the final rule to be published before the end of this calendar year.

Within our Single Family operations, we have made significant progress in our post-endorsement review process. This year we implemented a new algorithm for selecting recently insured loan files for post-endorsement technical reviews. This enhancement gives us a more precise way to conduct quality control reviews. Today, loans are selected for review based on a cascade of loan level characteristics that target risk, making our efforts much more effective and efficient.

To address system and staff constraints, we have been working with Congress to increase staff and technical capacity to handle the increased volume and market dynamics we currently face. We are focused on technology modernization and have teams in place working to upgrade our technology systems. We have a long way to go, but we successfully delivered FHA's first comprehensive technology transformation plan to Congress last September, which we have been implementing throughout this year. In addition, we recently awarded contracts to begin upgrading our risk and fraud tools. We are well underway to awarding additional contracts, and we continue to make progress modernizing FHA's technology infrastructure.

Finally, Mr. Chairman, since I arrived in July 2009, we have added 118 net new hires to Housing's payroll, and I have implemented an aggressive training and human capital development plan that includes managerial and technical skill building training as well as on-the-job mentoring.

Commitment to Comprehensive FHA Reform

Of course, the job is far from over. As important as the new premium authority established under H.R. 5891 is, Secretary Donovan and I remain committed to comprehensive FHA reform legislation that enhances FHA's lender enforcement capabilities and risk management efforts critical to our ability to monitor lender performance and ensure compliance. As already mentioned, we hope Congress will pass comprehensive FHA legislation before the end of the year.

Let me take this opportunity to once again thank this Committee for its work on H.R. 5072. Your efforts not only led to passage of comprehensive FHA reform by a substantial margin in the House but also laid the ground work for a companion Senate FHA reform bill, introduced by Senators Mark Begich and Sherrod Brown.

FHA remains committed to working with Congress to enact the full breadth of reforms introduced in H.R. 5072 and S. 3704, sponsored by Senators Begich and Brown. In addition to provisions strengthening FHA's lender enforcement ability, the legislation also includes technical clarifications that will allow for third party loan originators to close FHA insured loans in their name. This third party provision is particularly important to ensuring that several hundred community banks are able to continue originating FHA loans.

Additionally, HUD is seeking Congressional authority to extend FHA's ability to hold all lenders to the same standard and permit FHA to recoup losses through required indemnification for loans that were improperly originated and for which the error may have impacted the original loan decision, or in which fraud or misrepresentation were involved. FHA currently has this authority for loans originated through the Lender Insured (LI) process, which accounts for 70 percent of FHA loan volume, but only 29 percent of FHA-approved lenders. FHA is asking that Congress grant explicit authority to require indemnification for loans that were improperly originated for the remaining 71 percent of FHA-approved lenders. FHA is simply requesting that Congress permit FHA to hold all lenders to the same standard; FHA is not asking for expansion of authorities beyond those already granted to FHA to oversee lenders participating in the LI program. Moreover, this legislation will enable FHA to prevent lenders who have demonstrated poor performance in one area of the country from engaging in FHA lending nationwide, because it is often only a matter of time before a lender that has shown it is unable or unwilling to engage in prudent lending in one geographic region exhibits the same recklessness and irresponsibility somewhere else.

Facilitating our Recovery and Protecting the Taxpayer

Chairman Frank and Ranking Member Bachus, as you can see, we have proposed a comprehensive set of reforms to improve loan performance, hold lenders accountable, and increase revenues to the FHA fund, while also ensuring that FHA continues to support the overall recovery of the housing market and fulfill its mission of providing homeownership opportunities for responsible borrowers.

However, shoring up the FHA won't solve all our housing challenges, which is why 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 financing remains available until private capital returns. Thus, while we must remain mindful that qualified, responsible families need the continued ability to purchase a home, the changes and legislative requests that we have announced are crafted to ensure that FHA steps back to facilitate the return of the private sector as soon as possible.

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 expanded role that we play in today's market. The bottom line is this: the loans FHA insures must be safe and self-sustaining over the long-term. With these reforms the Administration is committed to ensuring that they are today – and into the future. We look forward to working with Congress closely on all these issues and hope to gain your support for our legislative requests to further reduce risks to the American taxpayer.

Thank you again for this opportunity to testify. I would be glad to respond to any questions.