TRANSPORTATION AND HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2008

THURSDAY, MARCH 15, 2007

U.S. SENATE,
SUBCOMMITTEE OF THE COMMITTEE ON APPROPRIATIONS,
Washington, DC.

The subcommittee met at 9:30 a.m., in room SD–138, Dirksen Senate Office Building, Hon. Patty Murray (chairman) presiding.

Present: Senators Murray and Bond.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

FEDERAL HOUSING ADMINISTRATION

STATEMENT OF HON. BRIAN D. MONTGOMERY, ASSISTANT SECRETARY FOR HOUSING AND FEDERAL HOUSING COMMISSIONER

ACCOMPANIED BY:

HON. KENNETH M. DONOHUE, INSPECTOR GENERAL, OFFICE OF INSPECTOR GENERAL

WILLIAM B. SHEAR, DIRECTOR, FINANCIAL MARKETS AND COMMUNITY INVESTMENT, GOVERNMENT ACCOUNTABILITY OFFICE

OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. This subcommittee will come to order. This morning, this subcommittee will hear testimony on the Federal Housing Administration. We will discuss the overall solvency of its mortgage lending program as well as the administration's proposal for reforming the FHA.

I am pleased that our Federal Housing Commissioner, Brian Montgomery, is here. He is joined by HUD Inspector General Kenneth Donahue and witnesses from the GAO, Mortgage Bankers Association and the National Association of Realtors.

Over the last 73 years of its existence, the FHA has served as a powerful engine to expand home ownership across the country. It has played a critical and essential role in providing access to capital for low-and-moderate income families. Most recently, however, the FHA has come to look more and more like an anachronism. Critics have said that they are out of touch with the marketplace, their mortgage products are outdated, they are a technological dinosaur and they are hard to do business with.

In recent years, the FHA has captured a smaller and smaller percentage of the overall mortgage market and its decline has been a rapid one. In my State, we have the Washington State Housing

Finance Commission, whose mission, like the FHA's, is to serve low-and-moderate income homebuyers. The Commission's Executive Director recently told me that in my State, the FHA's role in his efforts have been turned upside down in just the last 10 years. A decade ago, FHA covered 80 percent of the loan activity in his agency. Today, it only covers 20 percent.

When you look at all mortgage lending, FHA now represents roughly 3 percent of total mortgage volume nationwide. Now, some observers like to argue that whenever the private sector can replace the government in providing essential services, it's a good thing. In this case, I'm not so sure.

The FHA's loan products have fallen out of favor in part because private lenders have aggressively marketed subprime loans to high-risk borrowers. Some of these lenders have used temporary rate discounts or teaser rates, to push low-income borrowers into exotic loans with high fees and penalties that they can barely understand, much less afford. Some of these lenders have been boosting loan volume by taking credit standards to new lows and demanding almost no proof of income or credit worthiness.

As a result, we are now seeing rapidly rising foreclosures and some of the most aggressive subprime lenders are shuttering their operations. Just 2 days ago, the Mortgage Bankers Association released their updated survey on mortgage delinquencies. It revealed that foreclosures of subprime mortgages had reached a record high. The share of subprime borrowers making late payments rose to more than 13.3 percent.

That same day, the second largest subprime mortgage lender, New Century Financial, was de-listed from the New York Stock Exchange and announced that it had received criminal inquiries from both the Securities and Exchange Commission and State regulators. Those announcements sent the stock market into a tailspin. By the end of the day, the Dow Jones Industrial Average had dropped nearly 250 points or almost 2 percent. Financial stocks dropped even faster, falling almost 3.3 percent for the day.

The collapse of the subprime mortgage market has elicited warnings from Federal Reserve Board Chairman. Some economists have even predicted that the ripple effects of this collapse could eventually trigger a recession. These dire predictions should worry us all but should surprise no one.

It is estimated that one in five new mortgages written in recent years fell into the subprime category—one in five. This year alone, some $1.2 trillion in mortgages will have their interest rate reset upward. Some borrowers took out these adjustable rate loans banking on the fact that they would have an opportunity to either refinance their loan or if necessary, sell their home. Now the prepayment penalty is built into many of these loans as well as the overall downturn in home prices, means these opportunities have disappeared.

Many economists have said that our mortgage markets are in for a very rough road ahead. There is concern that this market upheaval could trigger a market over-reaction, where the availability of mortgage loan capital for working families tightens dramatically or just evaporates. If the mortgage market overreacts and working families need help, they may have to rely on the FHA. That means we need to make sure the FHA is strong and effective.

Today, the FHA's overall financial picture is weak. Absent the enactment of reform legislation this year, we are told that for the first time in its history, the FHA could require a direct appropriation to subsidize loan operations. This subcommittee could be required to appropriate $143 million in 2008, just to keep FHA's loan activities in the black. That is $143 million we won't be able to put toward section 8 recipients, homeless programs and other HUD programs serving needy citizens.

Currently, a growing percentage of the FHA's loan volume is not for traditional home mortgages for new homeowners. Rather, an increasingly popular FHA product appears to be reverse mortgages for elderly homeowners. This is a worthwhile program that keeps elderly families with fixed incomes in their homes. But getting younger Americans into their first home has always been central to FHA's historical mission. And in these tumultuous times, I think we need to work to make sure that the FHA can once again be relevant in that market.

This subcommittee continues to receive reports from the Government Accountability Office and the Inspector General indicating continuing problems with the currency of FHA's data, the sufficiency of its underwriting and the agency's technological obsolescence. The Bush administration put forward a reform proposal for the FHA in the last Congress. We expect it to be resubmitted in this Congress. Enactment of this FHA reform, we are told, should eliminate the need for any appropriated subsidy and make the FHA more competitive with the private market.

But this subcommittee and the rest of Congress need to look at these proposals very carefully. We need to make sure that we are not encouraging FHA to engage in some of the same high-risk, high-cost lending practices that are now upsetting the markets and putting relatively new homeowners out of their homes. The FHA is the taxpayers' mortgage lender. As such, it has an obligation to protect consumers. The FHA has specific statutory mandates to employ measures to keep families in their homes. These are requirements and obligations that private lenders do not have.

If the recent upheaval in mortgage lending means that private loan capital dries up for our working class families, we must make sure that the FHA is poised to keep the dream of home ownership alive. But the FHA must re-establish itself as America's mortgage lender, not by imitating the marketing and underwriting practices of New Century Financial. Rather, they must work to ensure that working families are getting into homes with loans that they can fully understand and afford.

With that, I would like to recognize my ranking member, Senator Bond.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Thank you very much, Madam Chair and a warm welcome to our witnesses for this important hearing on the FHA. We are focused primarily today on the single-family insured programs under the Mutual Mortgage Insurance Fund.

Madam Chair, you've done a very good job of outlining all of the challenges and the problems but since this is the Senate, it's not enough that you have said it. I'm going to say it, too. So if you'll bear with me.

As I said, we have a wide cross-section of witnesses who I expect can give us their views and positions, which should help provide a foundation for meaningful and comprehensive FHA reform. FHA has been enormously successful in assisting millions of Americans realize the dream of home ownership and I credit FHA's professional workforce and its leadership for these accomplishments.

However, FHA's history is also marked by longstanding challenges in balancing risk against expanding home ownership, especially for low income and first time homebuyers. Not too long ago, FHA was operating at record profit levels for the Federal Government. Now, FHA is at a serious crossroads and the question today is, how do we move forward in the best interests of the American taxpayer and those who wish to pursue home ownership?

In fairness, the Appropriations Committee should follow the lead of the Banking Committee in addressing FHA. Nevertheless, our committee has a substantial interest in the financial stability and solvency of FHA, since potential cost savings from FHA reform legislation could be used to support funding the needs of a number of popular housing programs.

In fact, the committee has been instrumental in some of the most recent significant FHA legislative changes, from raising the loan limits in 1988, which this committee did, when I was chair and working with Senator Mikulski on the VA/HUD Subcommittee, to increasing access to the reverse mortgage program and we've been able to reinvest those cost savings from the reforms to address other critical housing needs.

On the other side, if FHA needs an appropriation, that will take away from some of our ability to fund other needed housing assistance programs. Regardless of the outcome, we have to find a way to make these programs work and fund them adequately.

There are also a number of philosophical and practical issues surrounding FHA reform. We must consider to what extent FHA is still relevant or needed in the home ownership marketplace. If needed and relevant, Congress must consider how to ensure it can become and continue to be a viable player in the marketplace.

In addition to its loan products, we should examine changes to FHA's structure so it has the tools to operate competitively and efficiently as any other large financial institution. For example, I'm interested in converting FHA into a quasi-governmental entity so that it can hire and retain highly skilled people and it can keep pace with technological advances.

Finally, we must examine whether FHA can properly balance the risks and benefits of home ownership so that the interest of the borrower and the American taxpayer are adequately protected. It's clear that something must be done, since FHA seems to be cracking. In recent years, FHA has been plagued by rising default rates, higher than expected program costs and a sharp decline in program participation. In fact, the Mortgage Bankers Association's most recent survey reported record delinquency rates for FHA loans.

More disturbing is MBA's finding that FHA delinquency rates were similar, if not higher, than subprime loans. Further, FHA's share of the single-family market dropped by 40 percent in fiscal year 2005, with it's overall market share dropping from 12 percent in fiscal year 2002 to less than 4 percent in 2006 and this decline occurred during a period when overall home sales were increasing.

To be blunt, in every HUD budget hearing over the last few years, I have raised concerns about the viability and future of FHA. Nevertheless, it has been business as usual and Congress was advised that the FHA's future was bright. But the facts obviously indicate otherwise. The situation is now so dire that without any significant changes and reforms, FHA's MMI fund is projected to operate at a net loss in 2008, requiring a positive credit subsidy—a direct appropriation from this committee, for the first time in history.

This would be tragic, since other HUD programs are already being severely squeezed by budget constraints. The budget request, however, does not propose any appropriation to cover the positive credit subsidy and instead, the FHA Commissioner will raise premiums to ensure FHA's solvency. HUD's hope for improving FHA's long-term health is tied to the proposed reform legislation, which is assumed in the administration's 2008 budget request. It's always a risky matter to assume that Congress will get something done. That's our problem, not yours. But it is a problem for all of us.

HUD expects the legislation will grow FHA's receipts by increasing its mortgage loan limits as well as by implementing a new risk-based pricing and flexible down payment system. HUD's optimism depends on its ability to implement quickly and effectively the legislation. As we know, HUD does nothing quickly, since most proposals get caught up in an inflexible and multi-layered bureaucracy that can take years to act and that, again, is demonstrated by past experience.

To me, the most troubling provision is the zero down payment program. This could pose substantial risk to the MMI fund because these homebuyers have no financial stakes in their homes and have little financial ability to pay for any big ticket repair item, such as a failed furnace or a leaky roof. Historically, FHA suffered substantial losses in the late 1980's due to defaults by families with high loan-to-value or LTV ratios. Not only did the practice of high LTV loans damage the credit-worthiness of families who defaulted on their mortgages but equally troubling, as again our former committee colleague, Senator Mikulski pointed out, the defaults drove down the value of other housing in the neighborhood and transformed the neighborhoods into severely distressed and blighted areas. Sadly, some of these neighborhoods still suffer from those past mistakes.

Many in Congress support the administration's proposal but I question the practical impact of these proposals since they do not appear to address adequately the financial solvency of FHA or its underlying operational problems. Providing FHA with new loan products will have questionable impact since FHA continues to struggle in managing risk and ensuring accountability for its existing programs.

But don't just take that from me. Take this from Congress's official budget scorekeeper, the Congressional Budget Office. CBO last year estimated FHA's legislative reform package would result in a cost savings of about $2.3 billion over 5 years. However, about $2.2 billion or 95 percent of those savings were attributed to what is basically an accounting maneuver. Moving the successful FHA program, the home equity conversion mortgage or reverse mortgage program, from the GI/SRI fund account to the MMI fund account. Now, back when I used to play sports, we were always on the lookout for some guy who would change the score on the scorebooks when it wasn't that way in the field. We used to call that pencil-whipping and I am not a golfer but I understand that sometimes occurs in golf. Well, to me, this is the equivalent of pencil-whipping in government accounting and I have a minimum amount of high enthusiasm for that. That does not meet the "show me" test for Missouri.

The key elements of the administration's reform package, increasing loan limits and implementing a new risk based pricing system, will not significantly increase FHA's business and will not result in significant cost savings, according to CBO. Preliminary estimates of CBO's updated analysis will show almost no cost savings from these provisions. Frankly, we're facing a positive credit subsidy mainly due to FHA's self-inflicted wounds.

The GAO's testimony indicates that a large factor in the FHA recent financial problems is due to high claim and loss rates for seller financed down payment assistance loans, many of which were financed by nonprofit organizations. Thankfully, the Internal Revenue Service issued a ruling last May that may stem this practice. IRS is examining 185 of these organizations on their 501(c)3 status but I strongly urge FHA to take its own actions in addressing this matter.

I also remind you that this down payment practice is similar and is identical in practical impact to the zero down payment proposal where the homeowner has no real stake in his or her new home. There is a history lesson to be learned here and I surely hope we've learned from our mistakes.

I trust this hearing is just the beginning of a real debate on FHA reform. If we do reform and revitalize FHA, we must fully understand the financial risks of any legislation as well as understand what steps HUD has taken and plans to take to reduce the risk of fraud and abuse in its FHA mortgage programs.

I thank you for your tolerance in letting me get it off my chest and I return to the chair.

[The statement follows:]

PREPARED STATEMENT OF SENATOR CHRISTOPHER S. BOND

Good morning and thank you, Madame Chair, for calling this important hearing on the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). Today, we primarily are focused on FHA's single-family programs insured under the Mutual Mortgage Insurance (MMI) Fund. This is a timely hearing given the declining state of FHA and the recent woes in the mortgage market driven by the crash of the subprime market.

We are fortunate to have a broad range of witnesses before us today. I expect to hear a wide variety of views and positions, which should help provide a foundation for meaningful and comprehensive FHA reform.

FHA has been enormously successful in assisting millions of Americans realize the dream of homeownership and I credit FHA's professional workforce and its leadership for these accomplishments. However, FHA's history also is marked by longstanding challenges in balancing risk against expanding homeownership, especially for low-income and first-time homebuyers. Not too long ago, FHA was operating at record profit levels for the Federal Government. Now, FHA is at a serious crossroads and the question today is how do we move forward in the best interests of the American Taxpayer and those who still wish to pursue homeownership?

In fairness, the Appropriations Committee should follow the lead of the Banking Committee in addressing FHA. Nevertheless, our committee has substantial interest in the financial stability and solvency of FHA since potential cost savings derived from FHA reform legislation could be used to support the funding needs of a number of popular housing programs. In fact, this committee has been instrumental in some of the most recent significant FHA legislative changes—from raising the loan limits in 1998, which I did as chair of the VA–HUD Subcommittee, to increasing access to the reverse mortgage program—and we have reinvested the cost savings from those reforms to address other critical housing needs. Regardless of the outcome of FHA reform legislation, we must find a way to fund adequately these programs.

There also are a number of philosophical and practical issues surrounding FHA reform. We must consider to what extent FHA is still relevant or needed in the homeownership marketplace. If needed and relevant, Congress should consider how to ensure it can become and continue to be a viable player in the marketplace. In addition to its loan products, we should examine changes to FHA's structure so that it has the tools to operate competitively and efficiently as any other large financial institution. For example, I am interested in converting FHA into a quasi-governmental entity so that it can hire and retain highly-skilled people and it can keep pace with technological advances. Finally, we must examine whether FHA can properly balance the risks and benefits of homeownership so that the interests of the borrower and the American Taxpayer are adequately protected.

It is clear that something must be done since the FHA seems to be cracking. In recent years, FHA has been plagued by rising default rates, higher than expected program costs, and a sharp decline in program participation. In fact, the Mortgage Bankers Association's most recent survey reported record delinquency rates for FHA loans. More disturbing is MBA's finding that FHA delinquency rates were similar if not higher than subprime loans! Further, FHA's share of the single family market dropped by 40 percent in fiscal year 2005 with its overall market share dropping from 12 percent in fiscal year 2002 to less than 4 percent in fiscal year 2006. And this decline occurred during a period when overall home sales were increasing.

To be blunt, in every HUD budget hearing over the last few years, I have raised concerns about the viability and future of FHA. Nevertheless, it has been business as usual and the Congress was advised that FHA's future was bright. But the facts obviously indicate otherwise. The situation is now so dire that without any significant changes and reforms, FHA's MMI Fund is projected to operate at a net loss in fiscal year 2008, requiring a positive credit subsidy—meaning a direct appropriation—for the first time in history. This would be tragic since other HUD programs are already being severely squeezed by budget constraints. The budget request, however, does not propose any appropriation to cover the positive credit subsidy and instead, the Commissioner will raise premiums to ensure FHA's solvency.

HUD's hope for improving FHA's long-term health is tied to proposed reform legislation, which is assumed in the administration's fiscal year 2008 budget request. HUD expects this legislation will grow FHA receipts by increasing its mortgage loan limits as well as by implementing a new risk-based pricing and flexible down-payment system. HUD's optimism depends on its ability to implement quickly and effectively the legislation. As we know, HUD does nothing quickly since most proposals get caught up in an inflexible and multi-layered bureaucracy that can take years to act.

The most troubling provision is a new zero-down-payment program. This could pose substantial risks to the MMI Fund because these homebuyers have no financial stake in their homes and have little financial ability to pay for any big ticket repair item such as a failed furnace or a leaky roof. Historically, FHA suffered substantial losses in the late 1980s due to defaults by families with high loan-to-value (LTV) ratios. Not only did the practice of high LTV loans damage the creditworthiness of families who defaulted on their mortgages but, equally troubling, the defaults drove down the value of other housing in the neighborhood and transformed the neighborhoods into severely distressed and blighted areas. Sadly, some of these neighborhoods still suffer from those past mistakes.

Many in Congress support the administration's proposals but I question the practical impact of these proposals since they do not appear to address adequately the financial solvency of FHA or its underlying operational problems. Providing FHA with new loan products will have questionable impact since FHA continues to struggle in managing risk and ensuring accountability for its existing programs. But don't just take this from me. Take this from Congress's official budget scorekeeper, the Congressional Budget Office (CBO). Last year, the CBO estimated FHA's legislative reform package would result in a cost savings of about $2.3 billion over 5 years. However, about $2.2 billion or 95 percent of the savings were attributed to what is basically an accounting maneuver—moving the most successful FHA program, the Home Equity Conversion Mortgage or "reverse" mortgage program from the GI/SRI Funds account to the MMI Fund account.

The key elements of the administration's reform package—increasing loan limits and implementing a new risk-based pricing system—will NOT significantly increase FHA's business and will NOT result in significant cost savings according to CBO. Preliminary estimates of CBO's updated analysis will show almost NO cost savings from these provisions.

Frankly, we are facing a positive credit subsidy mainly due to FHA's self-inflicted wounds. The GAO's testimony indicates that a large factor in FHA's recent financial problems is due to high claim and loss rates for seller-financed down-payment assistance loans—many of which were financed by non-profit organizations. Thankfully, the Internal Revenue Service (IRS) issued a ruling last May that may stem this practice. IRS is examining 185 of these organizations on their 501(c)(3) status but I strongly urge FHA to take its own actions in addressing this matter. I also remind you that this downpayment practice is similar to the zero down-payment proposal where the homeowner has no real stake in his new home. There is a history lesson to be learned here and I strongly hope we will have learned from our mistakes.

I trust this hearing is just the beginning of a real debate on FHA reform. If we do reform and revitalize the FHA, we must fully understand the financial risks of any legislation as well as understand what steps HUD has taken and plans to take to reduce the risk of fraud and abuse in its FHA mortgage programs.

Thank you, Senator Murray.

Senator MURRAY. Thank you very much, Senator Bond.

I want to turn to our witnesses. Welcome all of you today. Thank you so much for coming and giving us your input today. We have in front of us, Brian Montgomery, who is the Assistant Secretary for Housing; Kenneth Donohue, the Inspector General from the Department of Housing and Urban Development; William Shear, who is Director of Financial Markets and Community Investment with GAO; JoAnne Poole, with the National Association of Realtors; and John Robbins with the Mortgage Bankers Association. Welcome, all of you. We would ask that each one of you limit your remarks to 5 minutes. I will let you know when the time is up. All of your testimony will be submitted for the record. We all have it and we will make sure all of our committee members have it as well. So we will be limiting you to 5 minutes so that we can get to our questions and answers today.

Mr. Montgomery, we will begin with you.

STATEMENT OF HON. BRIAN D. MONTGOMERY

Mr. MONTGOMERY. Thank you, Chairwoman Murray and ranking member Bond for inviting me here today. Our hard work on FHA reform during the 109th Congress paid off to the tune of 107 cosponsors, nearly evenly split from both sides of the aisle, I might add in a resounding 415 to 7 vote on the floor of the House as well as a separate 412 to 4 vote on the manufactured housing reforms.

Keeping that in mind, I would like to emphasize that our priorities for FHA legislation have not significantly changed from last year. As was our goal 1 year ago, we are striving to provide lower income families safe, secure home ownership opportunities. The simplicity lies with our mission, to provide underserved Americans a safe housing product at a fair price. As this committee is well aware, many first-time and minority homebuyers face significant challenges when trying to purchase a home. In recent years, such difficulties have resulted in many of these individuals assuming risky, adjustable rate, subprime loans.

The impact on African American and Latino borrowers has been especially profound. For instance, according to the 2004 HUMDA data, 40 percent of African Americans and 23 percent of Latinos pay an interest rate 3 percentage points higher than the market rate. When these homebuyers signed off on their loans, the built-in resets and rate increases seemed like a lifetime away. Today, however, many of these borrowers face a different reality.

According to mortgage strategists, some $2 trillion of U.S. mortgage debt or about a quarter of all mortgage loans are due for interest resets in 2007 and 2008. While some borrowers will make the higher payments, many will struggle.

The second component to our approach is that it is comprehensive. In light of recent housing market shifts and the departure of a strong subprime presence, due in large part to the resets I just mentioned, many lending institutions are simply turning their backs on lower income borrowers.

And just as the national housing market is tightening, so too are borrower requirements. In order to offset this tightening of credit, there needs to be a mortgage alternative, which will provide a wide slough of borrowers and simultaneously provide them with the loan options they require and that is a new and invigorated FHA.

As I've already mentioned, the changes we are proposing are not new. For one, we're proposing to eliminate our complicated down payment formula, our 3 percent minimum cash investment and before the rest of the market began offering low down payment loans, we were the best option for first time homebuyers because we required only a minimal down payment. But as many of you are aware, the market passed FHA by and as reported by the National Association of Realtors, last year 43 percent of first time homebuyers purchased their homes with no down payment. Of those who did put money down, the majority put down 2 percent or less.

The down payment is the biggest barrier to home ownership in this country, especially for lower income families. But we have no way to address that barrier without changes to our statute. The FHA Modernization Act would permit borrowers to choose how much to invest, from almost no money down to 1 or 2 or even 10 percent. The bill also provides FHA the flexibility to set the insurance premiums commensurate with the risk of a loan. We would charge lower credit risk borrowers a lower premium than they would get today and higher credit risk borrowers, many of whom we are unable to reach today, would be charged a slightly higher premium. In so doing, we could reach deeper into the pool of prospective borrowers while protecting the financial soundness of the MMI fund.

A slightly higher premium would increase a borrower's monthly payment only minimally. For example, the average FHA loan in 2006 is only $128,000. On a monthly basis, this loan would cost the borrower $7.96 at 1 percent, $16 at 2 percent and only $24 at 3 percent. Clearly, this high premium is still affordable.

Now, compare this modest premium to the average subprime loan made on a $225,000 home purchase and the numbers become far more meaningful. On average, subprime borrowers pay an interest rate three points higher than conventional borrowers and this rate hike translates into an additional $300 per month, which is $137,000 over the life of a loan.

Another piece of the legislation I'd like to mention is the proposed increase to our loan limits. By increasing the loan limit to 65 percent and 100 percent of the conforming loan limit, we would once again be a player in high cost states, regions that have previously been out of play, such as the entire State of California and most of the Northeast.

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What's more, raising the floor to 65 percent of the conforming loan limit has the added benefit of again giving families better access to newly constructed housing, which is on average, more costly.

I look forward to answering your questions. Thank you.

[The statement follows:]

PREPARED STATEMENT OF HON. BRIAN D. MONTGOMERY

Thank you Chairwoman Murray and Ranking Member Bond for inviting me to testify on the administration's proposed FHA Modernization. We plan to submit legislation soon that would implement the proposals included in the 2008 budget.

We all worked hard in the 109th Congress with many of you here today, and our message was well received. I hope our collaborative efforts on behalf of low- and moderate-income families can be a model for the 110th Congress.

As you are all aware, the Federal Housing Administration was created in 1934 to serve as an innovator in the mortgage market, to meet the needs of citizens otherwise underserved by the private sector, to stabilize local and regional housing markets, and to support the national economy. This mission is still very relevant, perhaps now more so than ever.

Moreover, the FHA model represents the very best of what a government working with the private sector can and should do. Since its inception, FHA has helped more than 34 million Americans become homeowners. By operating through a private sector distribution network, FHA efficiently reaches families in need of safe and affordable home financing. Simply put, FHA insurance protects lenders against loss, enabling these private sector partners to offer market-rate mortgages to homebuyers who would otherwise remain unserved or underserved.

FHA also protects the homebuyer. FHA offers foreclosure prevention alternatives that are unparalleled in the industry. In fiscal year 2006 more than 75,000 FHA insured borrowers facing serious default were able to retain homeownership through FHA's toolbox of foreclosure prevention options. In an environment of increasing defaults, FHA's foreclosure rate actually decreased last year. This protection against foreclosure is good for families and good for communities. It also resulted in $2 billion in loss avoidance for the Insurance Fund, which illustrates our commitment to sound financial management.

We believe that FHA should continue to play a key role in the national mortgage market and I'm here today to make the case for changes to the National Housing Act that will permit us to continue to fulfill our critical mission.

Allow me to explain. In recent years, FHA's outdated statutory authority has left the agency out of synch with the rest of the lending industry. Over the last decade, the mortgage industry transformed itself, offering innovative new products, risk-based pricing, and faster processing with automated systems. Meanwhile, FHA continued to offer the same types of products with the same kinds of pricing, becoming less attractive to lenders and borrowers alike.

As a result, FHA's volume has dropped precipitously in housing markets all across the Nation. For example, in Chairwoman's Murray's home State of Washington, FHA's volume has dropped from 16,806 loans in 2000 to 6,477 loans in 2006 (a decline of 61 percent or almost $1.2 billion). For Ranking Member Bond, during that same time period, FHA's volume in Missouri dropped from 15,172 to 8,979 loans (a decline of 41 percent or $262 million).

But the most troublesome statistic of all comes from Senator Feinstein's home State of California. There, FHA saw its volume drop from 109,074 in 2000 to just 2,599 in 2006—an astonishing decline of 98 percent in just 6 years.

These statistics suggest that tens of thousands of low- and moderate-income families who would have chosen FHA turned to alternative methods of mortgage finance. While many of them were well-served, some were not and turned to expensive and sometimes risky exotic loans. We see today the unfortunate outcomes such families across the Nation are experiencing.

To offer a better and more attractive mortgage product, over the last 18 months we have made significant administrative changes to FHA, streamlining and realigning operating procedures. While these changes are good and were long overdue, they are not enough, a point our industry partners have clearly conveyed to us and to you. That is why last year FHA requested that Congress amend the National Housing Act to give it the flexibility it needs to fulfill its original mission in today's ever changing marketplace.

As the dynamic mortgage market passed FHA by, many homebuyers, especially those living in higher cost States such as California, New York, and Massachusetts, to name a few, purchased mortgage products with conditions and terms they would not be able to meet.

Some homebuyers turned to high-cost financing and nontraditional loan products to afford their first homes. While low initial monthly payments may have seemed like a good thing at the time, the reset rates on some interest-only loans are substantial and many families have been and will continue to be unable to keep pace when the payments increase. In addition, prepayment penalties often times make refinancing cost-prohibitive. According to Mortgage Strategist, more than $2 trillion of U.S. mortgage debt, or about a quarter of all mortgage loans outstanding, is due for interest rate resets in 2007 and 2008. While some borrowers will make the higher payments and many others will refinance, some will struggle and some will be forced to sell or lose their homes to foreclosure. I'm sure it comes as no surprise to the people in this room that the foreclosure rate for subprime loans is higher than that of FHA loans. And I think we can all agree that foreclosures are bad for families, bad for neighborhoods, and bad for the economy as a whole.

In the context of this economic environment, we see FHA Modernization as part of the solution. FHA reform is designed to restore a choice to homebuyers who can't qualify for prime financing and more options for all potential FHA borrowers.

Moreover, the FHA bill proposes changes that will strengthen FHA's financial position, improving FHA's ability to mitigate and compensate for risk. The proposed changes would permit FHA to operate like every other insurance company in the Nation, pricing its products commensurate with the risk, as opposed to having some clients pay too much and some too little. Imagine if a car insurance company charged all clients the same premium—the 17-year-old teenager and a 40-year-old adult would pay the same rate. Is that fair? With a blended rate, those who know they're paying too much switch to another insurance company. That leads to a portfolio that is increasingly lopsided: too many riskier borrowers, too few safer borrowers, and collectively poses greater risk to an insurance fund. This scenario, known as adverse selection is exactly what happened to FHA over the last decade. Those who were lower credit risks went elsewhere. The premium changes proposed in the administration's proposal will restore balance to the FHA funds, providing appropriate levels of revenue to operate in a more fiscally sound manner.

While we are on the topic of the soundness of the insurance fund, I am proud to report that the OIG found no material weaknesses in its fiscal year 2006 audit of the FHA, and that in January 2007, the GAO removed FHA's single family mortgage insurance programs from its high risk list. Both of these developments reflected improvements that HUD has made in recent years in its management of property disposition contractors, its oversight of lenders, its implementation of a mortgage scorecard, and its ability to predict claims and estimate credit subsidy costs.

I know my introduction was lengthy, but I want you to understand how important FHA reform really is—for FHA, for the homebuyers we serve, and for the industry as a whole. FHA's private sector partners—the lenders, the realtors, the brokers, the home builders—want to tell their clients about the FHA alternative. They want low- to moderate-income homebuyers to have a safer, more affordable financing option. They want FHA to be a viable player again.

Now let me explain a little bit about the simple changes we're proposing. For one, we're proposing to eliminate FHA's complicated downpayment calculation and 3 percent cash investment requirement. Before the rest of the market began offering low downpayment loans, FHA was often the best option for first-time homebuyers because it required only a minimal downpayment. But, as I said before, the market passed FHA by. According to the National Association of Realtors, last year, 43 percent of first-time homebuyers purchased their homes with no downpayment. Of those who did put money down, the majority put down 2 percent or less.

The downpayment is the biggest barrier to homeownership in this country, but FHA has no way to address the barrier without changes to its statute. FHA Modernization would permit borrowers to choose how much to invest, from no money down to 1 or 2 or even 10 percent and to be charged appropriate premiums for the size of the downpayment they make.

The proposal also provides FHA the flexibility to set the FHA insurance premiums commensurate with the risk of the loans. For example, no downpayment loans would be priced slightly higher, yet appropriately, to give homebuyers a fairly-priced option and to ensure that FHA's insurance fund is compensated for taking on the additional risk. FHA would also consider the borrower's credit profile when setting the insurance premium. FHA would charge lower-credit risk borrowers a lower insurance premium than it does today, and higher-credit risk borrowers would be charged a slightly higher premium. In so doing, FHA could reach deeper into the pool of prospective borrowers, while protecting the financial soundness of the FHA Fund and creating incentives for borrowers to achieve good credit ratings and save for downpayments.

A slightly higher premium would increase a borrower's monthly payment only minimally. For example, on a $225,000 loan, a 1 percent upfront premium financed into the loan would cost the borrower $13.97 per month; a 2 percent premium would cost $27.94 and a 3 percent premium, $41.90. Clearly, this higher premium is still affordable. Moreover, it's a smart investment, because the borrower is paying for the FHA insurance to obtain a market rate loan.

Some say that with a risk-based pricing approach FHA will target people who shouldn't be homebuyers and charge them more than they should pay. I want to address these concerns directly. Our goal is to reach families who are capable of becoming homeowners and to offer them a safe and fairly-priced loan option.

With a risk-based premium structure, FHA can reach hard-working, credit-worthy borrowers—store clerks, bus drivers, librarians, social workers—who, for a variety of reasons, do not qualify for prime financing. Some have poor credit scores due to circumstances beyond their control, but have put their lives back together and need a second chance. For some, the rapid appreciation in housing prices has simply outpaced their incomes. Many renters find it difficult to save for a downpayment, but have adequate incomes to make monthly mortgage payments and do not pose a significant credit risk. They simply need an affordable financing vehicle to get them in the door. FHA can and should be there for these families.

If granted, FHA's new legislative authorities would save homeowners a lot of money, because FHA's loan product would carry a lower interest rate than a non-prime loan product. The higher premiums that FHA will charge some types of borrowers are still substantially lower than they would pay for subprime financing. For example, if FHA charged a 3 percent upfront insurance premium for a $225,000 loan to a credit-impaired borrower versus that same borrower obtaining a subprime loan with an interest rate 3 percent above par, the borrower would pay over $300 more in monthly mortgage payments with the subprime loan and over $137,000 more over the life of the loan. In addition, FHA borrowers do not have to be concerned about teaser rates, unmanageable interest rate increases or prepayment penalties.

Moreover, FHA intends to lower the insurance premium for many borrowers. FHA will charge lower-risk borrowers a substantially lower premium than these types of borrowers pay today. For example, homebuyers with higher credit scores who choose to invest at least 3 percent in a downpayment may pay as little as .075 of a percent upfront premium.

So while FHA may charge riskier borrowers more (and safer borrowers less) than it does today, the benefit is four-fold. First, FHA will be able to reach additional borrowers the agency can't serve today. Second, many borrowers will pay less with FHA than with a subprime loan. Third, the FHA Fund will be managed in a financially sound manner, with adequate premium income to cover any expected losses. Finally, borrowers will be rewarded for maintaining good household financial practices that lead to good credit ratings and higher savings for a downpayment.

Another change proposed in FHA Modernization is to increase FHA's loan limits. Members of Congress from high-cost states have repeatedly asked FHA to do something about our antiquated loan limits. This proposal answers those concerns. FHA's loan limit in high-cost areas would rise from 87 to 100 percent of the GSE conforming loan limit; in lower-cost areas, the limit would rise from 48 to 65 percent of the conforming loan limit. In between high- and lower-cost areas, FHA's loan limit will increase from 95 to 100 percent of the local median home price. This change is extremely important and crucial in today's housing market. In many areas of the country, the existing FHA limits are lower than the cost of new construction. Buyers of new homes can't choose FHA financing in these markets. In other areas, most notably California, FHA has simply been priced out of the market.

Finally, FHA Modernization offers some changes to the Home Equity Conversion Mortgage (HECM) program, which enables senior homeowners, aged 62 years or older, to tap into their home equity to live comfortably in their golden years. The proposal eliminates the cap on the number of loans FHA can insure; it sets a single, national loan limit; and it creates a new HECM for Home Purchase product to permit seniors to move from the family home to more suitable senior housing and convert the purchase loan into a HECM in a single transaction. Today, seniors who want to move, but need additional cash flow to pay their living expenses, must purchase a new home and take out a HECM in two distinct transactions, resulting in two sets of loan fees and charges.

Let me repeat a point I made earlier in the testimony. I want to assure you that the changes we are proposing will not impose any additional budgetary cost. We are proposing to manage the Fund in a financially prudent way, beginning with the change in FHA pricing to match premiums with risk. This will avoid FHA being exposed to excessive risk, as it is today, because some borrowers who use FHA are under-charged for their risk to the Fund while those who are overcharged are fleeing from the program. Of course, we will continue to monitor the performance of our borrowers very closely, and make adjustments to underwriting policies and/or premiums as needed.

I know I've talked a lot here today, but I want to convey to you how passionate I am about the proposed changes. I believe we have an opportunity to make a difference in the lives of millions of low- and moderate-income Americans. We have a chance to bring FHA back into business, to restore the FHA product to its traditional market position. To all those families who can buy a home with prime conventional financing, I say, "Go for it!" They're fortunate and they should take full advantage of that product. But for those who can't, FHA needs to be a viable option. And when people ask me why we are proposing these changes, I tell them these exact words: "Families need a safe deal, at a fair price. Families need a way to take part in the American Dream without putting themselves at risk. Families need FHA."

I want to thank you again for providing me the opportunity to testify here today on modernizing the Federal Housing Administration. I look forward to working with all of you to make these necessary reforms a reality.

Senator MURRAY. Thank you very much. Mr. Donohue.

STATEMENT OF HON. KENNETH M. DONOHUE

Mr. DONOHUE. Chairman Murray, ranking member Bond and the members of the subcommittee, thank you for inviting me here to testify today. In January, the GAO announced the results of its high-risk series review. I want to commend the Department and FHA for the removal of its rental housing assistance and the single-family mortgage insurance program from the high-risk list, which they had been on since 1994.

This resolution, in part, is a result of ongoing dialogue between FHA and the OIG and is an excellent example of good government and positive change.

I come to you today with a note of warning for the FHA. There have been a lot of articles lately comparing the fall of the subprime lending market to that of the failed savings and loan institutions of the 1980's. I spent 7 years of the Resolution Trust Corporation uncovering the fraud and abuse among directors of failed savings and loans. I have seen first hand the damaging results of an unregulated and solely profit driven industry, results that ultimately cost the American taxpayer billions of dollars.

Whether we are just starting to see the tip of the iceberg today or actually seeing the iceberg in the subprime lending market remains to be seen. But unlike the savings and loan crisis, it will have a social impact as many honest, hardworking individuals may lose their homes. The mortgage industry has said they have increased home ownership, however, at what cost to the American people?

Relaxed underwriting practices instituted by unscrupulous subprime lenders, the usage of riskier products, like adjustable rate and interest only loans, coupled with appraisal fraud and lack of understandable disclosure of loan terms have made it easier for those who do not quality for prime loans to purchase homes but not retain them. In addition, while it might have been a splendid idea to help the troubled borrowers with low mitigation programs, it is worth remembering that the rollover non-performing loans added to the savings and loan mess of the 1990's.

With the current trend of interest rates in flux, the resulting payment shock and low home appreciation, due in part, to over building, we have seen States such as Colorado and we will probably continue to see increased delinquencies and foreclosure rates. Further, a number of these borrowers fell subject to additional hardship as predatory lenders applied aggressive sales tactics and outright fraud to finance the subprime loans. I am concerned as to whether FHA is headed in the same direction as the subprime market with a seemingly continued deregulation and introduction of riskier products as part of its proposed reform.

A chart produced by the Mortgage Bankers Association survey shows how closely the FHA delinquency rate follows that of the subprime market. We have an industry that is generally profit driven. However, with that should come responsibility. Unlike the mortgage industry, the FHA is mission driven. The FHA Single Family lending has experienced a market drop in insurance volume as subprime lending spiked and mortgage interest rates increased.

The numbers are disconcerting. In fiscal year 2006, insurance endorse was down 8 percent; new endorsements were off 17 percent and delinquent and default rates inched upward. History will actually reflect that FHA was spared the impact of the subprime prices because it did not contain these in its portfolio.

The FHA 2008 budget submission suggests that costs will exceed receipts. FHA may really be left with only two choices—to request a credit subsidy by means of appropriations or to increase the premiums to avoid a shortfall. Reform packets, which include risk based premiums, zero down payment loans and higher mortgage limits seems to be partly directed at high income housing markets to the possible detriment of first time homebuyers and minority customers.

PREPARED STATEMENT

I also want to stress, the proposed reform bill is silent on strengthening controls and enforcement action in preventing future fraud. As to our record, over the past 3 years, HUD/OIG has issued 190 auto reports to the area of FHA. These are reports that identified $1.1 billion in questionable costs and funds that could be put to a better use. During the same time period, the HUD/OIG had over 1,350 indictments and $1.3 billion in court-ordered restitutions. I cannot say the reform legislation is the answer and I recognize that some change is necessary. There are great challenges confronting the FHA programs; nevertheless, aggressive oversight and enforcement is crucial to prevent a reoccurrence of what we are witnessing in the subprime market today and the savings and loan industry in the past year. Clearly, there are lessons to learn from the repeat of history. Thank you.

[The statement follows:]

PREPARED STATEMENT OF HON. KENNETH M. DONOHUE

Chairman Murray, Ranking Member Bond, and members of the subcommittee, thank you for inviting me to testify today.

BACKGROUND

The U.S. Department of Housing and Urban Development (HUD) Inspector General is one of the original 12 Inspectors General authorized under the Inspector General Act of 1978. The Office of Inspector General (OIG) has forged a strong alliance with HUD personnel in recommending ways to improve departmental operations and in prosecuting program abuses. OIG strives to make a difference in HUD's performance and accountability. OIG is committed to its statutory mission of detecting and preventing fraud, waste, and abuse and promoting the effectiveness and efficiency of government operations. While organizationally located within the Department, OIG operates independently with separate budget authority. This independence allows for clear and objective reporting to the Secretary and the Congress.

The Department's primary challenge is to find ways to improve housing and to expand opportunities for families seeking to improve their quality of life. HUD does this through a variety of housing and community development programs aimed at helping Americans nationwide obtain affordable housing. These programs, which include Federal Housing Administration (FHA) mortgage insurance for Single Family and Multifamily properties, are funded through a $30+ billion annual budget and, in the case of FHA, through mortgage insurance premiums. At the end of fiscal year 2006, FHA's outstanding mortgage insurance portfolio was about $396 billion.

Each year in accordance with the Reports Consolidated Act of 2000, HUD OIG is required to submit a statement to the Secretary with a summary assessment of the most serious challenges facing the Department. OIG submitted its latest assessment on October 19, 2006. The Department has notably and laudably made progress in its efforts to correct its serious challenges. However, continued progression in the integration of FHA's financial management systems, and strengthening of lender accountability and enforcement against program abusers is still needed.

FHA is the largest mortgage insurer in the world, providing coverage to over 34 million home mortgages and 47,205 multifamily projects since 1934. FHA insurance protects HUD-approved lenders against losses should a homeowner or project owner default on their mortgage loans. FHA insures a wide spectrum of loans. Its single family programs include insuring mortgage loans to purchase new or existing homes, condominiums, manufactured housing, houses needing rehabilitation, as well as reverse equity mortgages to elderly homeowners. Its multifamily programs provide mortgage insurance to facilitate the construction, substantial rehabilitation, purchase and refinancing of multifamily housing projects and healthcare facilities.

On January 31, 2007, the Government Accountability Office (GAO) announced the results of its biennial "high-risk" series review. We commend the Department for the removal of its rental housing assistance and the single family mortgage insurance programs, which have been on GAO's risk list since 1994.

THE CHALLENGE

Chairman, ranking member, and members of the subcommittee, you have probably read or seen a number of articles of late comparing the fall of the subprime lending market to that of the failed savings and loan institutions of the 1980's. I spent 7 years at the Resolution Trust Corporation as Assistant Director for Investigations, uncovering the fraud and abuse among directors of the failed savings and loan institutions. I have seen first hand the damaging results of a solely profit-driven industry, which ultimately cost the American taxpayer billions of dollars.

Whether we are just starting to see the "tip of the iceberg" today or are actually seeing the iceberg in the subprime lending market remains to be seen, but like the savings and loan crisis, it will not only have a financial impact but a social impact as many honest, hard working individuals may lose their homes. The mortgage industry has said they have increased homeownership; however, at what cost to the American people?

The Senate Committee on Banking, Housing and Urban Affairs recently held a hearing on subprime lending. The testimony included estimates that as many as 2.2 million families may lose their homes to foreclosure—foreclosures that were often predictable or avoidable through responsible lending. We see this today in the State of Colorado, where it is estimated that two out of every five home loans is a subprime loan. Colorado has not only ranked among the top States for mortgage fraud during the last 2 years, but has held the highest foreclosure rate in the Nation for most of 2006.

Relaxed underwriting practices instituted by unscrupulous subprime lenders, the usage of "riskier" products (e.g., adjustable-rate and interest-only loans)—coupled with appraisal fraud—and lack of understandable disclosure of loan terms have made it easier for those who do not qualify for prime loans to purchase homes but not retain them. With the current trend of rising interest rates and the resulting payment shock, and low home appreciation—due in part to overbuilding that we have seen in States, such as Colorado—we will probably continue to see increasing delinquency and foreclosure rates. Further, a number of these borrowers may fall subject to additional hardship as their subprime loans are refinanced by predatory lenders who apply aggressive sales tactics and outright fraud.

I am concerned as to whether FHA is headed in the same direction as the subprime market with its seemingly continued de-regulation and introduction of "riskier" products as part of its proposed reform. A chart produced by the Mortgage Bankers Association National Delinquency Survey shows how closely the FHA delinquency rate—as a loan type—follows that of the subprime market. To further illustrate in the third quarter of 2006, delinquencies for subprime past due loans were at 12.56 percent (up 7 percent from the second quarter of 2006 and up 17 percent from the third quarter in 2005), while total delinquencies for all past due loans were at 4.67 percent. Ninety-day delinquencies for subprime loans stood at 2.96 percent, while all other loans were at 0.94 percent. Foreclosure starts for subprime loans was at 1.82 percent, while for all other loans only 0.46 percent began foreclosure in the third quarter of 2006.

We have an industry that is generally profit-driven, and primarily concerned with the bottom line; however, with that should come responsibility. Unlike the mortgage industry that is primarily profit driven, the FHA is mission driven.

FHA RISK

FHA single family lending has experienced a marked drop in insurance volume, as subprime lending spiked and mortgage interest rates increased. The numbers are disconcerting: in fiscal year 2006 insurance in force (active mortgages) was down 8 percent, new endorsements were off 17 percent, and delinquency and default rates inched upward. Does this scenario mean FHA faces a financial crisis? Not based on the recent actuarial findings that estimate a capital ratio of 6.82 percent for the Mutual Mortgage Insurance (MMI) fund that well exceeds the 2 percent capital ratio mandated by the 1990 Cranston-Gonzalez National Affordable Housing Act. FHA actuaries found the MMI fund to be adequately capitalized to defray expected claims cost over the next decade including losses from the hard hit Gulf coast region, which is estimated at $613 million. Revenue shortfalls from insurance premiums were predicted, but they were offset by expected interest income from Treasury investments.

FHA's fiscal year 2008 budget submission casts a somewhat different light as it concerns the risk of the MMI fund. It states: "Because of adverse loan performance and improved estimation techniques, the base line credit subsidy rate for FHA's single family program—assuming no programmatic changes—is positive, meaning that total costs exceed receipts on a present value basis, and therefore would require appropriations of credit subsidy budget authority to continue operation. The 2008 baseline includes no budget authority to cover these costs and assumes FHA would use its existing authorities to increase premiums to avoid the need for credit subsidy appropriations. Under the Budget's proposals, FHA will be able to set premiums that are based on risk and are sufficient to avoid the need for credit subsidy appropriations." (emphasis added)

Simply, FHA may be really left with only two choices, to request a credit subsidy by means of appropriations or increase its premiums to avoid an estimated shortfall of $143 million in fiscal year 2008. One FHA response to this impending predicament is through the passage of "The Expanding American Homeownership Act." In his June 20, 2006 testimony, the FHA Commissioner stated, ". . . the FHA bill proposes changes that will strengthen FHA's financial position, improving FHA's ability to mitigate and compensate risk. The proposed changes would permit FHA to operate like every other insurance company in the Nation, pricing its products commensurate with the risk, as opposed to having some clients pay too much and some too little.” Regardless of whether the FHA reforms are enacted, as FHA takes on more risk—as has been the trend in recent years—we believe premiums will also need to increase or Congress may have to subsidize the program.

Moreover, I remain somewhat concerned over the proposed modernization of FHA and whether the reforms will provide a panacea to its “loss of market” woes and ensure the future solvency of the MMI fund. The reform package—which includes risk-based premiums, zero-downpayment loans, and higher mortgage limits—seems to be partially directed at expanding FHA’s reach to the higher income housing market to the possible impact on its traditional first-time homebuyer and minority customers. These reform package proposals merit further discussions, including the following:

Risk-Based Premiums

Moving to a mixed price premium structure: (1) could by its very complexity require increased budget authority to make FHA system modifications and impose new administrative/cost burdens on originating and servicing lenders; and (2) potentially expose the FHA Single Family insurance program to fair housing questions and accusations of “red-lining” unless the decision matrix for pricing is unquestionable.

FHA customers traditionally have been first-time homebuyers and minorities, some with incomplete or flawed credit histories and marginal reserves to avoid default when facing financial stress. FHA reform will require these higher risk borrowers to pay higher premiums. Risk-based pricing, therefore, may increase the mortgage carrying costs of FHA borrowers that are the least able to afford them.

Zero Down Payment

As the actuaries have pointed out, FHA is currently experiencing higher default and claim rates on seller-funded nonprofit down payment assisted loans, which are effectively zero down payment loans (100 percent loan-to-value). GAO reported in 2005 the probability of such loans resulting in an insurance claim was 76 percent higher than comparable loans without such assistance. It is reasonable to conclude that zero down payment loans would represent a comparable insurance risk. Additionally, in light of current congressional and GSE (Freddie Mac and Fannie Mae) concerns over the growth of subprime lending and growing default rates, FHA should be wary of inviting future claim risks by insuring 100 percent and greater (after financing closing costs and insurance premiums) loan-to-value loans.

Higher Mortgage Limits

FHA should determine mortgage loan limits consistent with its mission to serve underserved borrowers and communities, particularly first-time homebuyers and minorities. Raising the loan limits to GSE conforming maximums may serve to attract borrowers who have access to conventional financing, and do not need a government program to acquire homeownership.

Raising FHA area loan limits, especially the high-cost area ones, will not necessarily help low- and moderate-income families become homeowners. In some markets, raising the base limit would mean that FHA would insure homes well above the median house price statewide, further distancing FHA from its mission, and potentially exposing the MMI fund to increased risk from regional economic downturns. If the limits for 2–4 unit properties are also included, FHA will be assuming even greater financial risk on what are essentially investment properties.

Unless there is evidence to show otherwise—the reforms may actually increase the mortgage burden of the qualified, but less creditworthy borrowers and reward those with greater financial stability. And one could argue that FHA appears to be strategizing to capture some share of the prime market and borrowers already served by conventional lending.

Moreover, the proposed reform is silent on strengthening controls and enforcement actions and preventing future fraud. As we have seen over the last 2 years, FHA has made changes to its operations, which in some instances has included deregulation—without seemingly proper risk analysis—out of concern over retaining market share. However, there has been some change; most notably the Deputy Secretary recently supported our recommendation that Housing (FHA) rescind the issuance of Mortgagee Letter 2005–23, which removed the “. . . six-month payment history requirement for loans submitted late for endorsement.” Our audit found that loans with an unacceptable payment history—within the prior 6 months to submission—were at least 3.5 times higher risk of claims to the MMI fund.

The OIG recognizes that there is an important call for action to avoid the need for the Congress to subsidize the program; however, the introduction of “riskier” products through reform must be balanced with more effective program fraud controls to mitigate future insurance losses and ensure oversight of lenders that violate established requirements. For example, our recent audit of the single family mortgage insurance claim process determined that, prior to paying billions of dollars in single family insurance claims, FHA did not independently ascertain whether loans insured under the MMI fund met program requirements. Housing disagreed with our recommendations which included FHA establishing a risk-based post claim review process and seeking recovery or adequate support for final HUD costs for 44 unsupported claims identified in our sample totaling over $1.3 million in losses.

The private sector has pointed to one remedy to reduce fraud in mortgage loan programs. Mortgage bankers are beginning to use predictive models that screen loan applications for fraud at pre-funding. FHA needs to move beyond post endorsement monitoring and embrace this new technology through policy and programmatic changes, as part of FHA reform.

Lastly, the actuaries did not evaluate MMI fund solvency, assuming the proposed FHA reform became law. It would seem prudent for FHA to have its actuaries prepare another study to reflect likely performance scenarios before introducing the reforms to the mortgage market.

In spite of these differences, we are encouraged to work collectively with FHA. In 2006, the Mortgage Bankers hosted a fraud symposium, which we attended and were an active participant. We hope such collaboration can serve as a model for all our future cooperative efforts including those with the FHA.

CONTINUING OIG AREAS OF CONCERN

Even though the Department has notably made progress in its efforts to correct its serious challenges—supported by recent removal from GAO's high-risk list—as GAO cautions, HUD needs to manage new risks and accurately estimate the costs of program changes. The following are continuing areas of concern that we have identified through our audit and investigative efforts over the FHA single family and multifamily insurance programs.

Down Payment Assistance

Until recently, HUD has not been responsive to the universal concern that seller-funded nonprofit down payment assistance providers inflate real estate prices and increase the risk of default. OIG's concerns with down payment assistance from seller-funded nonprofits have been long-standing and are consistent with concerns raised by others. The FHA was not responsive to our concerns and that of the GAO until the Internal Revenue Service issued a revenue ruling making it clear that seller funded down payment assistance providers are not charities as they do not meet the requirements of 26 U.S.C. § 501(c)(3). This ruling enabled us to convince the Department to compel FHA to issue a rule that will establish specific standards regarding borrower investments in a mortgage property when a gift is provided by a nonprofit organization.

The Department has committed to a schedule that will result in a final rule being issued next summer. However, it is important to note that until this rule is issued, the status quo remains the same and nonprofit down payment assisted loans will continue to have a negative impact on the economic value of the MMI fund.

Loan Case Binder Access

FHA has adopted an ill-advised policy that permits those with the potential to perpetrate fraud upon the insurance fund to maintain the original records/certifications associated with their fraud. Through the issuance of Mortgage Letter 2005–36, the Lender Insurance (LI) Program enables certain FHA-approved Direct Endorsement lenders to endorse FHA loans without a pre-endorsement review and generally relieves LI lenders from the responsibility of submitting loan originations case binders to FHA.

We expressed our concerns over the various LI Program provisions that may adversely impact the ability to investigate and prosecute fraud perpetrated upon FHA. Also, we obtained a letter of opposition from the FBI, alerted OMB to the issuance of the mortgagee letter, apprised Senate and House oversight staff, and gained support of the Office of General Counsel (OGC). In spite of the best efforts of many, FHA implemented the program; with assurances to the OGC and us that it would collaborate with interested parties to make technical corrections once the program was implemented. More than 1 year later, FHA has yet to schedule the first meeting to discuss needed technical corrections.

Single Family Fraud

In my experience, over 99 percent of people are honest, while less than 1 percent is intent on defrauding others. Their impact can be, however, quite detrimental. Organized groups or individuals driven by the bottom line are defrauding consumers and FHA, at the same time that FHA is seemingly pursuing a policy of de-regulation. We continue to compile evidence through our audit and investigative activities of organized groups and individuals who conspire to take advantage of first-time homebuyers and minority customers. These groups and individuals conspire, with or without the borrowers' knowledge, to provide materially false applications, documents and statements to obscure information that would otherwise demonstrate that borrowers do not qualify for the loans they seek or that the property in question does not meet FHA insurance guidelines.

OIG is also seeing a trend with organized groups in some parts of the country recruiting illegal aliens to purchase FHA-insured homes. Illegal aliens are not qualified to purchase FHA-insured homes due to their immigration status. As a result, this group is often preyed upon by unscrupulous mortgage professionals who assist illegal aliens in obtaining fraudulent and stolen social security numbers, tax documents, and employment documents. All too frequently these borrowers soon realize that they are unable to bear the periodic costs associated with homeownership and default on their loan. In turn, these ever increasing defaults degrade entire communities where the organized groups target their efforts. As a result of FHA's continued pattern of de-regulation or inconsistent enforcement of established regulations, single family loans remain vulnerable to fraud.

Multifamily Fraud

FHA does not have adequate controls to prohibit equity skimming in nursing homes. In consideration for endorsement for insurance by FHA, prospective nursing home mortgagor/owners are required to execute a regulatory agreement. The regulatory agreement is FHA's chief vehicle to protect its financial and programmatic interests in the mortgaged property. Typically, the mortgagor/owner does not "operate" the nursing home and leases the property to a lessee/operator that executes a separate and less comprehensive regulatory agreement. Numerous OIG audits have determined that FHA does not have adequate controls in place to ensure program objectives are accomplished.

Among the significant control weaknesses identified by the OIG is that the regulatory agreement used for the lessee/operator-managed nursing homes lacks certain requirements contained in the regulatory agreement applicable to mortgagor/owner-managed nursing homes. The regulatory agreement used for lessee/operator-managed nursing homes does not preclude the lessee/operator from diverting all or any portion of the income generated by the property to non-property purposes to the detriment of the elderly tenants, and HUD who is subject to the payment of an insurance claim to the lender due to the mortgagor/owner's default on the FHA-insured loan.

Gulf Coast

Congress estimates that damage to residential structures will range from $17 to $33 billion. In the Presidentially Declared Disaster Areas, HUD's FHA single family insurance fund insured more than 328,000 mortgages having an unpaid principal balance of $23 billion. FHA's multifamily program in the Presidentially Declared Disaster Areas insured 528 projects with an amortized principal balance of $3 billion. Of these, 112 or 21 percent sustained more than minor damage, resulting in significant potential losses. Further, the actuaries have estimated the expected claim losses caused by the hurricanes to be $613 million.

The devastation caused by Hurricanes Katrina and Rita, and more importantly the unprecedented volume of Federal assistance provided in reaction to the hurricanes, has created an environment ripe for fraud. OIG will continue to focus, to the greatest extent possible, on the ultimate disposition and accountability of these funds.

THE RECORD

Pursuant to goal number 1 of HUD–OIG's Strategic Plan, to help HUD resolve its major management challenges by being a relevant and problem-solving advisor to the Department, we continue to focus our audit and investigative efforts on FHA to include both single family and multifamily insurance programs. Over the past 3 years, HUD OIG has issued 190 audit reports in the area of FHA. These FHA-related audit reports identified over $1.1 billion in questioned costs and funds that could be put to better use. During the same time period, the HUD OIG had 1,078 cases opened. The following are examples of our audit and investigative activities.

Office of Audit

Single Family

We audited a San Antonio, Texas financial firm because of an unusually high ratio of defaults. We found that 47 percent of its defaults involved one seller, who owned 50 percent of the lender. OIG reviewed 51 of the defaulted loans that involved the seller. The lender approved mortgages on overvalued properties because the lender allowed an identity-of-interest seller to add ineligible and unsupported construction costs and inadequately reviewed the appraisals. Also, the lender did not adequately document analyses of borrowers' credit. Further, the lender's processing had technical difficulties. Consequently, HUD and the borrowers unnecessarily incurred increased risks through higher insurance exposure and higher mortgage payments as evidenced by the borrowers defaulting on their mortgages.

HUD OIG audited a Miamisburg, Ohio lender approved to originate, underwrite, and submit insurance endorsement requests under HUD's single family direct endorsement program. We selected it for audit because of its high late endorsement rate. This lender submitted 2,071 late requests for endorsement out of 68,730 loans tested. The loans were either delinquent or otherwise did not meet HUD's requirement of six consecutive timely payments after delinquency but before submission to HUD. It also incorrectly certified that both the mortgage and escrow accounts for 133 loans and the escrow account for taxes, hazard insurance premiums, and mortgage insurance premiums for 497 loans were current.

HUD OIG audited a Phoenix, Arizona mortgage company's insured loan originations due to high default and claim rates. It did not originate the 19 loans reviewed in compliance with HUD requirements or prudent lending practices. All 19 loans involved origination deficiencies that should have precluded their approval, including false employment data, overstated income, understated liabilities, unacceptable credit histories, improper treatment of downpayment gifts and/or interest rate buydowns resulting in over insured mortgages, inaccurate or excessive qualifying ratios without compensating factors, and borrower overcharges for unsupported or unallowed fees. As a result, it placed HUD's single family insurance fund at risk for 19 unacceptable loans with original mortgages totaling more than $2.5 million, and borrowers were overcharged $9,400. HUD remains at risk and/or has incurred losses totaling more than $1.2 million related to 15 of the 19 loans.

Multifamily

HUD OIG audited six housing projects in Los Angeles, California, to assess HUD's concerns over inappropriate disbursements and determine whether the projects were administered in compliance with HUD requirements. The owner and identity-of-interest management agent used project funds to pay more than $2.6 million in ineligible and unsupported costs, including excessive and unreasonable charges by an identity-of-interest maintenance contractor, excessive charges for the management agent's president, unsupported rent charges and capital improvement expenses for the management agent's office, and ineligible ownership expenses. OIG anticipates similar additional questionable costs continued after the end of the audit period that could cost the projects another $457,000. OIG's building inspections identified more than 240 health or safety violations, which resulted in more than $561,000 in housing assistance payments for units and buildings that were not decent, safe, and sanitary. In addition, the owner and identity-of-interest management agent did not effectively manage the projects, to include not accurately calculating, reporting, and resolving more than $655,000 in project liabilities.

In Bethany, Oklahoma we audited a HUD-insured nursing home to determine whether it complied with the regulatory agreement and HUD requirements when disbursing project funds. We found its officials used $2.3 million for ineligible costs, such as loan repayments and late fees, and could not support $4.5 million in expenditures. Further, these officials did not provide documentation to support the use of revenue amounting to nearly $12 million. This ultimately resulted in mortgage default and closure of the nursing home.

We completed an audit of a rehabilitation center in Carmichael, California. We found that the owner incorporated the project in its petition for bankruptcy and then defaulted on the project's mortgage. In addition, the owner disbursed $3.7 million in project funds through ineligible cash distributions and expenses. These activities resulted in increased risk to HUD, the assignment of the mortgage note to HUD, and HUD's resulting loss of $323,000 on the sale of the note.

Office of Investigation

Single Family

Seven Charlotte, NC residents were indicted by a Federal grand jury on 66 counts alleging conspiracy, wire fraud, bank fraud, making false statements and entries, and money laundering. The Defendants owned and operated a mortgage brokerage corporation. The scheme entailed defrauding HUD and the Government National Mortgage Association (GNMA) whose mission is to support affordable home ownership in America by providing an efficient government secondary market vehicle to link the capital and Federal housing markets. A bundle of loans, usually totaling $1 million, is packaged by a lender and sold to investors as a pool for which it is required that an actual existing dwelling is constructed and that a homeowner is submitting monthly mortgage payments. GNMA is the final guarantor of the loan pools and mortgage-backed securities and will fully reimburse the investors should the need arise.

The Defendants are alleged to have devised and executed an elaborate mortgage fraud scheme to generate over 100 loans that were purported to be FHA-insured loans on nonexistent properties that were ultimately resold to investors in mortgage pools backed by GNMA, as well as the Federal National Mortgage Association (FNMA). GNMA was required to make the investors whole when the fraud was discovered. The defendants would recruit strawbuyers to secure fraudulent FHA-insured home loans through a builder and these loans, in most cases, were secured by properties that were vacant lots or for homes belonging to legitimate homeowners. The Defendants allegedly received the loan proceeds and used the money for their personal benefit and to advance the fraud scheme.

As a result of the fraud, the Defendants obtained more than $5 million from FNMA and more than $26 million from GNMA. The investigation was initiated based on GNMA having discovered irregularities during an audit of the builder. The GNMA losses are based on the cost to repurchase each fraudulent loan from GNMA investors. The defendants also fraudulently obtained a $5 million line of credit with a banking and trust company by submitting straw mortgages and false documents. This investigation has resulted in the seizure of assets worth $8 million.

OIG investigated a large mortgage company in Detroit, Michigan and confirmed that it submitted to FHA as many as 28,000 loans with underwriter's certifications purportedly signed by one of two FHA-approved underwriters. In actuality, however, these loans had been underwritten by other staff, who had not received FHA-approval and who merely signed the FHA-approved underwriters' names on the certifications. OIG referred the matter to the United States Attorney's Office for the Eastern District of Michigan, which entered into a civil settlement valued at in excess of $40 million. This figure covered FHA's experienced and forecast losses on the loans, and included a penalty.

Four defendants were charged in a scheme in Colorado for assisting unqualified and undocumented immigrants in obtaining more than 300 FHA-insured loans valued in excess of $61 million. As a result of foreclosures, HUD realized losses of $2.3 million.

Multifamily

The owner of a mortgage company and four HUD-insured nursing homes located in Rhode Island and the administrator of the nursing homes, and others, illegally diverted income or funds from the nursing homes to themselves or identity-of-interest companies authorizing payments for unwarranted services while the properties were in a non-surplus-cash position, a violation of their HUD regulatory agreement. As a result of their actions, HUD realized a loss of $14 million when the owner defaulted on the HUD-insured mortgages for 2 of the nursing homes. For the remaining 2 nursing homes, HUD continues litigation over the $13 million insurance payment of one nursing home and continues operations of the other—which is listed for sale—with a $9.7 million FHA-insured mortgage. In addition, the portfolio contains approximately 57 FHA-insured loans estimated at $314.3 million, all of which are considered at risk.

CONTINUED SUPPORT

We continue to support the Department and FHA's mission and will also continue to increase our efforts to ensure the administrative health and vitality of HUD's programs and activities. I know that with the hard work of staff, we will persist in a pattern of improved oversight and enforcement and I look forward to working with the Department to come up with common and workable solutions. I would like to mention the notable remarks made by the Secretary in recent testimony on March 1, 2007, that borrowers should be paying a portion of the downpayment when obtaining an FHA-insured loan. As we know, without a financial stake in a home, borrowers have less incentive to be responsible homeowners making it easier to default and walk away.

That is where HUD comes in, to ensure Americans are given the opportunity to obtain and retain affordable housing. However, this cannot be driven solely by the Federal Government, but must also be done through a collective effort that combines the expertise of the housing industry of both the public and private sector.

I cannot say that the reform legislation is the answer and I recognize that some change is necessary. There are great challenges confronting FHA programs. Nevertheless, aggressive oversight and enforcement is crucial to prevent a recurrence of what we are witnessing in the subprime market today and the savings and loan industry in years past. Clearly, there are lessons learned from repeats of history.

CONCLUSION

That concludes my testimony and I thank the subcommittee for holding this hearing and I look forward to answering questions that members may have.

Senator MURRAY. Mr. Shear.

STATEMENT OF WILLIAM B. SHEAR

Mr. SHEAR. Thank you. Madam Chairman, Senator Bond and members of the subcommittee, it is a pleasure to be here this morning to share information and perspectives as the committee examines issues concerning the financial performance of FHA.

Although the program currently operates with a negative subsidy, the risks FHA faces in today's mortgage market are growing. Because of the worsening performance of the mortgages it insures, FHA has estimated that the program would require a positive subsidy—that is, an appropriation of budget authority—in fiscal year 2008 if no program changes were made.

To help FHA adapt to market changes, HUD has proposed a number of changes to the National Housing Act that would provide FHA flexibilities. A major theme of our testimony today is that whether under its existing authority or using any additional flexibility that Congress may grant, FHA's ability to manage both risk and program changes will affect the financial performance of the insurance program.

Our testimony discusses four reports that we have issued since 2005, plus some related information from ongoing work we're conducting at the request of Senators Allard and Shelby.

In summary, our work identified a number of weaknesses in FHA's ability to estimate and manage risk that may affect the financial performance of the insurance program.

First, FHA has not developed sufficient standards and controls to manage risks associated with a substantial proportion of loans with down payment assistance, including assistance from nonprofit organizations funded by home sellers. According to FHA, high claim and loss rates for loans with such assistance were major reasons for the estimated positive subsidy cost for fiscal year 2008, absent any program changes.

Second, FHA has not consistently implemented practices, such as stricter underwriting or piloting used by other mortgage institutions to help manage the risks associated with new product offerings. Although FHA has indicated that it would impose stricter underwriting standards for a no-down-payment mortgage if the legislative changes were enacted, it does not plan to pilot the product.

Third, the way that FHA developed its mortgage scorecard, while generally reasonable, limits how effectively it assesses the default risk of borrowers. With increased competition from conventional mortgage providers, limitations in its scorecard could cause FHA to insure mortgages that are relatively more risky. Our ongoing work indicates that FHA plans to use the scorecard to help set insurance premiums if legislative changes are enacted. Accordingly, any limitations in the scorecard's ability to predict defaults could result in FHA mispricing its products.

Fourth, although FHA has improved its ability to estimate the subsidy costs for its single-family insurance program, it generally has underestimated these costs. Increases in the expected level of claims were a major cause of a particularly large re-estimate that FHA submitted as of the end of fiscal year 2003.

We have made several recommendations in our recent reports, including that FHA: (1) incorporate the risk posed by down payment assistance into its scorecard; (2) study and report on the impact of variables not in its loan performance models that have been found to influence credit risk; and (3) consider piloting new products.

PREPARED STATEMENT

FHA has taken actions in response to our recommendations, but continued focus on risk management will be necessary for FHA to operate in a financially sound manner in the face of market and program changes.

Madam Chairman, I would be happy to answer any questions at this time.

[The statement follows:]

PREPARED STATEMENT OF WILLIAM B. SHEAR

Madam Chairman and members of the subcommittee, I am pleased to have the opportunity to share information and perspectives with the committee as it examines issues concerning the financial performance of the Department of Housing and Urban Development's (HUD) Federal Housing Administration (FHA). FHA provides insurance for single-family home mortgages made by private lenders. In fiscal year 2006, it insured about 426,000 mortgages, representing $55 billion in mortgage insurance. According to FHA's estimates, the insurance program currently operates with a negative subsidy, meaning that the present value of estimated cash inflows (such as borrower premiums) to FHA's Mutual Mortgage Insurance Fund (Fund) exceeds the present value of estimated cash outflows (such as claims).

But, the risks FHA faces in today's mortgage market are growing. For example, the agency has seen increased competition from conventional mortgage and insurance providers, many of which offer low- and no-down-payment products, and that may be better able than FHA to identify and approve relatively low-risk borrowers. Additionally, because of the worsening performance of the mortgages it insures, FHA has estimated that the program would require a positive subsidy—that is, an appropriation of budget authority—in fiscal year 2008 if no program changes were made.

To help FHA adapt to market changes, HUD has proposed a number of changes to the National Housing Act that, among other things, would give FHA flexibility to set insurance premiums based on the credit risk of borrowers and reduce down-payment requirements from the current 3 percent to potentially zero. Whether under its existing authority or using any additional flexibility that Congress may grant, FHA's ability to manage risks and program changes will affect the financial performance of the insurance program.

My testimony today discusses 4 reports that we have issued since 2005 on different aspects of FHA's risk management, as well as ongoing work we are conducting on FHA's proposed legislative changes and the tools and resources it would use to implement them, if passed. This body of work addresses a number of issues relevant to FHA's financial performance. Specifically, I will discuss: (1) weaknesses in how FHA has managed the risks of loans with down-payment assistance; (2) practices that could be instructive for FHA in managing the risks of new mortgage products; (3) FHA's development and use of a mortgage scorecard; and (4) FHA's estimation of subsidy costs for its single-family insurance program.

In conducting this work, we reviewed and analyzed information concerning the standards and controls FHA uses to manage the risks of loans with down-payment assistance; steps mortgage industry participants take to design and implement low- and no-down-payment mortgage products; FHA's approach to developing its mortgage scorecard and the scorecard's benefits and limitations; FHA's estimates of program costs and the factors underlying the agency's cost reestimates; and FHA's plans and resources for implementing its proposed legislative changes. We interviewed officials from FHA, the U.S. Department of Agriculture, and U.S. Department of Veterans Affairs; and staff at selected private mortgage providers and insurers, Fannie Mae, Freddie Mac, the Office of Federal Housing Enterprise Oversight, selected State housing finance agencies, and nonprofit down-payment assistance providers. We conducted this work from January 2004 to March 2007 in accordance with generally accepted government auditing standards.

In summary, our work identified a number of weaknesses in FHA's ability to estimate and manage risk that may affect the financial performance of the insurance program:

FHA has not developed sufficient standards and controls to manage risks associated with the substantial proportion of loans with down-payment assistance. Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of down-payment assistance from nonprofit organizations that receive part of their funding from home sellers. However, our analysis of a national sample of FHA-insured loans found that the probability of loans with this type of down-payment assistance resulting in an insurance claim was 76 percent higher than comparable loans without such assistance. Additionally, the financial risks of these loans recently have been realized in effects on the credit subsidy estimates. According to FHA, high claim and loss rates for loans with this type of down-payment assistance were major reasons why the estimated credit subsidy rate—the expected cost—for the single-family insurance program would be positive, or less favorable, in fiscal year 2008 (absent any program changes).

Some of the practices of other mortgage institutions offer a framework that could help FHA manage the risks associated with new products such as no-down-payment mortgages. For example, mortgage institutions may limit the volume of new products issued—that is, pilot a product—and sometimes require stricter underwriting on these products. While FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance, it generally has done so in response to a legislative requirement and not on its own initiative. Moreover, FHA officials have questioned the circumstances under which pilot programs were needed and also said that they lacked sufficient resources to appropriately manage a pilot. However, FHA officials have indicated that they would institute stricter underwriting standards for any no-down-payment mortgage authorized by their legislative proposal.

While generally reasonable, the way that FHA developed its mortgage scorecard—an automated tool that evaluates the default risk of borrowers—limits the scorecard's effectiveness. More specifically, FHA and its contractor used variables that reflected borrower and loan characteristics to create the scorecard and an accepted modeling process to test the variables' accuracy in predicting default. But, the data used to develop the scorecard were 12 years old by the time that FHA began using the scorecard in 2004, and the market has changed significantly since then. In addition, the scorecard does not include all the important variables that could help explain expected loan performance such as the source of the down payment. With competition from conventional providers, limitations in the scorecard could cause FHA to insure mortgages that are relatively more risky. Our ongoing work indicates that FHA plans to use the scorecard to help set insurance premiums if legislative changes are enacted. Accordingly, any limitations in the scorecard's ability to predict defaults could result in FHA mispricing its products.

Although FHA has improved its ability to estimate the subsidy costs for its single-family insurance program, it generally has underestimated these costs. To meet Federal requirements, FHA annually reestimates subsidy costs for each loan cohort.[1] The current reestimated subsidy costs for all except the fiscal year 1992 and 1993 cohorts are less favorable—that is, higher—than originally estimated. Increases in the expected level of insurance claims—potentially stemming from

[1] Essentially, a cohort includes the loans insured in a given year.

changes in underwriting guidelines, among other factors—were a major cause of a particularly large reestimate that FHA submitted as of the end of fiscal year 2003.

On the basis of our findings from the reports I have summarized, we made several recommendations designed to improve FHA's risk management. For example, to improve its assessment of borrowers' default risk, we recommended that FHA develop policies for updating the scorecard, incorporate the risks posed by down-payment assistance into the scorecard, and explore additional uses for this tool. To more reliably estimate program costs, we recommended that FHA study and report in the annual actuarial review of the Fund the impact of variables not in the agency's loan performance models (the results of which are used in estimating and reestimating program costs) that have been found in other studies to influence credit risk.[2]

FHA has taken actions in response to some of our findings and recommendations. For example, FHA has developed and begun putting in place policies for annually updating the scorecard and testing additional predictive variables. To more reliably assess program costs, an FHA contractor incorporated the source of down-payment assistance and borrower credit scores in recent actuarial reviews of the Fund.

While these actions represent improvements in FHA's risk management, sustained management attention to the issues that we have identified and continued congressional oversight of FHA will play an important role in ensuring that FHA is able to expand homeownership opportunities for low- and middle-income families while operating in a manner that is financially sound.

BACKGROUND

Congress established FHA in 1934 under the National Housing Act (Public Law 73–479) to broaden homeownership, protect lending institutions, and stimulate employment in the building industry. FHA's single-family programs insure private lenders against losses (up to almost 100 percent of the loan amount) from borrower defaults on mortgages that meet FHA criteria. In 2005, more than three-quarters of the loans that FHA insured went to first-time homebuyers, and about one-third of these loans went to minorities. From 2001 through 2005, FHA insured about 5 million mortgages with a total value of about $590 billion. However, FHA's loan volume fell sharply over that period, and in 2005 FHA-insured loans accounted for about 5 percent of single-family home purchase mortgages, compared with about 19 percent in 2001.[3] Additionally, default rates for FHA-insured mortgages have risen steeply over the past several years, a period during which home prices have generally appreciated rapidly.

FHA determines the expected cost of its insurance program, known as the credit subsidy cost, by estimating the program's future performance.[4] Similar to other agencies, FHA is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. FHA has estimated negative credit subsidies for the Fund from 1992, when Federal credit reform became effective, through 2007. However, FHA has estimated that, assuming no program changes, the loans it expects to insure in fiscal year 2008 would require a positive subsidy, meaning that the present value of estimated cash inflows would be less than the present value of estimated cash outflows. The economic value, or net worth, of the Fund that supports FHA's insurance depends on the relative size of cash outflows and inflows over time. Cash flows out of the Fund for payments associated with claims on defaulted loans and refunds of up-front premiums on prepaid mortgages. To cover these outflows, FHA receives cash inflows from borrowers' insurance premiums and net proceeds from recoveries on defaulted loans. An independent contractor's actuarial review of the Fund for fiscal year 2006 estimated that the Fund's capital ratio—the economic value divided by the insurance-in-force—is 6.82 percent, well above the mandated 2 percent minimum.[5] If the Fund were to be exhausted, the U.S. Treasury would have to cover lenders' claims directly.

[2] Since 1990, the National Housing Act has required an annual and independent actuarial analysis of the economic net worth and soundness of the Fund. 12 U.S.C. section 1711(g).

[3] These figures represent mortgages for owner-occupied homes only.

[4] Pursuant to the Federal Credit Reform Act of 1990, HUD must annually estimate the credit subsidy cost for its mortgage insurance programs. Credit subsidy costs are the net present value of estimated payments HUD makes less the estimated amounts it receives, excluding administrative costs.

[5] In fiscal year 2006, the Fund's estimated economic value was $22 billion and the unamortized insurance-in-force was $323 billion.

Two major trends in the conventional mortgage market have significantly affected FHA.[6] First, in recent years, members of the conventional mortgage market (such as private mortgage insurers, Fannie Mae, and Freddie Mac) increasingly have been active in supporting low- and even no-down-payment mortgages, increasing consumer choices for borrowers who may have previously chosen an FHA-insured loan. Second, to help assess the default risk of borrowers, particularly those with high loan-to-value ratios (loan amount divided by sales price or appraised value), the mortgage industry has increasingly used mortgage scoring and automated underwriting systems.[7] Mortgage scoring is a technology-based tool that relies on the statistical analysis of millions of previously originated mortgage loans to determine how key attributes such as the borrower's credit history, property characteristics, and terms of the mortgage affect future loan performance. As a result of such tools, the mortgage industry is able to process loan applications more quickly and consistently than in the past. In 2004, FHA implemented a mortgage scoring tool, called the FHA Technology Open to Approved Lenders (TOTAL) Scorecard, to be used in conjunction with existing automated underwriting systems.

Partly in response to changes in the mortgage market, HUD has proposed legislation intended to modernize FHA. Provisions in the proposal would authorize FHA to change the way it sets insurance premiums and reduce down-payment requirements. The proposed legislation would enable FHA to depart from its current, essentially flat, premium structure and charge a wider range of premiums based on individual borrowers' risk of default. Currently, FHA also requires homebuyers to make a 3 percent contribution toward the purchase of the property. HUD's proposal would eliminate this contribution requirement and enable FHA to offer some borrowers a no-down-payment product.

FHA HAS NOT IMPLEMENTED SUFFICIENT STANDARDS AND CONTROLS TO MANAGE FINANCIAL RISKS OF LOANS WITH DOWN-PAYMENT ASSISTANCE

In our November 2005 report examining FHA's actions to manage the new risks associated with the growing proportion of loans with down-payment assistance, we found that the agency did not implement sufficient standards and controls to manage the risks posed by these loans.[8] Unlike other mortgage industry participants, FHA does not restrict homebuyers' use of down-payment assistance from nonprofit organizations that receive part of their funding from home sellers. According to FHA, high claim and loss rates for loans with this type of down-payment assistance were major reasons for changing the estimated credit subsidy rate from negative to positive for fiscal year 2008 (in the absence of any program changes). Furthermore, incorporating the impact of such loans into the actuarial study of the Fund for fiscal year 2005 resulted in almost a $2 billion (7 percent) decrease in the Fund's estimated economic value.

Loans With Down-Payment Assistance Are a Substantial Portion of FHA's Portfolio and Pose Greater Financial Risks Than Similar Loans Without Assistance

Homebuyers who receive FHA-insured mortgages often have limited funds and, to meet the 3 percent borrower investment FHA currently requires, may obtain down-payment assistance from a third party, such as a relative or a charitable organization (nonprofit) that is funded by the property sellers. The proportion of FHA-insured loans that are financed in part by down-payment assistance from various sources has increased substantially in the last few years, while the overall number of loans that FHA insures has fallen dramatically. Money from nonprofits funded by seller contributions has accounted for a growing percentage of that assistance. From 2000 to 2004, the total proportion of FHA-insured purchase loans that had a loan-to-value ratio greater than 95 percent and that also involved down-payment assistance, from any source, grew from 35 percent to nearly 50 percent. Approximately 6 percent of FHA-insured purchase loans in 2000 received down-payment assistance from nonprofits (the large majority of which were funded by property sellers), but by 2004 nonprofit assistance grew to about 30 percent. The corresponding percentages for 2005 and 2006 were about the same.

We and others have found that loans with down-payment assistance do not perform as well as loans without down-payment assistance. We analyzed loan performance by source of down-payment assistance, using two samples of FHA-insured purchase loans from 2000, 2001, and 2002—a national sample and a sample from three

[6] Conventional mortgages do not carry government insurance or guarantees.

[7] Underwriting refers to a risk analysis that uses information collected during the origination process to decide whether to approve a loan.

[8] GAO, Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance, GAO–06–24 (Washington, DC: Nov. 9, 2005).

metropolitan statistical areas (MSA) with high rates of down-payment assistance.[9] Holding other variables constant, our analysis indicated that FHA-insured loans with down-payment assistance had higher delinquency and claim rates than similar loans without such assistance. For example, we found that the probability that loans with nonseller-funded sources of down-payment assistance (e.g., gifts from relatives) would result in insurance claims was 49 percent higher in the national sample and 45 percent higher in the MSA sample than it was for comparable loans without assistance. Similarly, the probability that loans with nonprofit seller-funded down-payment assistance would result in insurance claims was 76 percent higher in the national sample and 166 percent higher in the MSA sample than it was for comparable loans without assistance. This difference in performance may be explained, in part, by the higher sales prices of comparable homes bought with seller-funded down-payment assistance. Our analysis indicated that FHA-insured homes bought with seller-funded nonprofit assistance were appraised and sold for about 2 to 3 percent more than comparable homes bought without such assistance. The difference in performance also may be partially explained by the homebuyer having less equity in the transaction.

Stricter Standards and Additional Controls Could Help FHA Manage the Risks Posed by Loans With Down-Payment Assistance

FHA has implemented some standards and internal controls to manage the risks associated with loans with down-payment assistance, but stricter standards and additional controls could help FHA better manage the financial risks posed by these loans while meeting its mission of expanding homeownership opportunities. Like other mortgage industry participants, FHA generally applies the same underwriting standards to loans with down-payment assistance that it applies to loans without such assistance. One important exception is that FHA, unlike others, does not limit the use of down-payment assistance from seller-funded nonprofits. Some mortgage industry participants view assistance from seller-funded nonprofits as a seller inducement to the sale and, therefore, either restrict or prohibit its use. FHA has not treated such assistance as a seller inducement and, therefore, does not subject this assistance to the limits it otherwise places on contributions from sellers.

Concerns about loans with nonprofit seller-funded down-payment assistance have prompted FHA and IRS to initiate steps that could curb their use. For example, FHA has begun drafting a proposed rule that, as described by FHA, would appear to prohibit down-payment assistance from seller-funded nonprofits. FHA's legislative proposal could also eliminate the need for such assistance by allowing some FHA borrowers to make no down payments for an FHA-insured loan. Finally, in May 2006, IRS issued a ruling stating that organizations that provide seller-funded down-payment assistance to home buyers do not qualify as tax-exempt charities. FHA permitted these organizations to provide down-payment assistance because they qualified as charities. Accordingly, the ruling could significantly reduce the number of FHA-insured loans with seller-funded down payments. However, FHA officials told us that as of March 2007, they were not aware of IRS rescinding the charitable status of any of these organizations.

Our report made several recommendations designed to better manage the risks of loans with down-payment assistance generally, and more specifically from seller-funded nonprofits. Overall, we recommended that in considering the costs and benefits of its policy permitting down-payment assistance, FHA also consider risk-mitigation techniques such as including down-payment assistance as a factor when underwriting loans or more closely monitoring loans with such assistance. For down-payment assistance providers that receive funding from property sellers, we recommended that FHA take additional steps to mitigate the risks of these loans, such as treating such assistance as a seller contribution and, therefore, subject to existing limits on seller contributions. In response, FHA agreed to improve its oversight of down-payment assistance lending by: (1) modifying its information systems to document assistance from seller-funded nonprofits; and, (2) more routinely monitoring the performance of loans with down-payment assistance. Also, as previously noted, HUD has initiated steps to curb and provide alternatives to seller-funded down-payment assistance.

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[9] The data (current as of June 30, 2005) consisted of purchase loans insured by FHA's 203(b) program, its main single-family program, and its 234(c), condominium program. The three MSAs were Atlanta, Indianapolis, and Salt Lake City.

PRACTICES THAT OTHER MORTGAGE INSTITUTIONS USE COULD HELP FHA MANAGE RISKS FROM LOW- OR NO-DOWN-PAYMENT PRODUCTS

If Congress authorized FHA to insure mortgages with smaller or no down payments, practices that other mortgage institutions use could help FHA to design and manage the financial risks of these new products. In a February 2005 report, we identified steps that mortgage institutions take when introducing new products.[10] Specifically, mortgage institutions often utilize special requirements when introducing new products, such as requiring additional credit enhancements (mechanisms for transferring risk from one party to another) or implementing stricter underwriting requirements, and limiting how widely they make available a new product. By adopting such practices, FHA could reduce the potential for higher claims on products whose risks may not be well understood.

Mortgage Institutions Require Additional Credit Enhancements, Stricter Underwriting, and Higher Premiums for Low- and No-Down-Payment Products

Some mortgage institutions require additional credit enhancements on low- and no-down payment products, which generally are riskier because they have higher loan-to-value ratios than loans with larger down payments. For example, Fannie Mae and Freddie Mac mitigate the risk of low- and no-down payment products by requiring additional credit enhancements such as higher mortgage insurance coverage. Although FHA is required to provide up to 100 percent coverage of the loans it insures, FHA may engage in co-insurance of its single-family loans. Under co-insurance, FHA could require lenders to share in the risks of insuring mortgages by assuming some percentage of the losses on the loans that they originated (lenders would generally use private mortgage insurance for risk sharing).

Mortgage institutions also can mitigate the risk of low- and no-down-payment products through stricter underwriting. Institutions can do this in a number of ways, including requiring a higher credit score threshold for certain products, requiring greater borrower reserves, or requiring more documentation of income or assets from the borrower. Although the changes FHA could make are limited by statutory standards, it could benefit from similar approaches. The HUD Secretary has latitude within statutory limitations to change underwriting requirements for new and existing products and has done so many times. For example, FHA expanded its definition of what could be included as borrower's effective income when calculating payment-to-income ratios. In commenting on our February 2005 report, FHA officials told us that they were unlikely to mandate a credit score threshold or borrower reserve requirements for a no-down-payment product because the product was intended to serve borrowers who were underserved by the conventional market, including those who lacked credit scores and had little wealth or personal savings. However, in the course of our ongoing work on FHA's legislative proposal, FHA officials indicated that they would likely set a credit score threshold for any no-down-payment product.

Finally, mortgage institutions can increase fees or charge higher premiums to help offset the potential costs of products that are believed to have greater risk. For example, Fannie Mae officials stated that they would charge higher guarantee fees on low- and no-down payment loans if they were not able to require higher insurance coverage.[11] Our ongoing work indicates that FHA, if authorized to implement risk-based pricing, would charge higher premiums for loans with higher loan-to-value ratios, all other things being equal.

We recommended that if FHA implemented a no-down-payment mortgage product or other new products about which the risks were not well understood, the agency should: (1) consider incorporating stricter underwriting criteria such as appropriate credit score thresholds or borrower reserve requirements; and, (2) utilize other techniques for mitigating risks, including the use of credit enhancements. In response, FHA said it agreed that these techniques should be evaluated when considering or proposing a new FHA product.

Before Fully Implementing New Products, Some Mortgage Institutions May Limit Availability

Some mortgage institutions initially may offer new products on a limited basis. For example, Fannie Mae and Freddie Mac sometimes use pilots, or limited offerings of new products, to build experience with a new product type. Fannie Mae and Freddie Mac also sometimes set volume limits for the percentage of their business

[10] GAO, Mortgage Financing: Actions Needed to Help FHA Manage Risks from New Mortgage Loan Products, GAO–05–194 (Washington, DC: Feb. 11, 2005).

[11] Fannie Mae and Freddie Mac charge fees for guaranteeing timely payment on mortgage-backed securities they issue. The fees are based, in part, on the credit risk they face.

that could be low- and no-down-payment lending. FHA has utilized pilots or demonstrations when making changes to its single-family mortgage insurance but generally has done so in response to legislative requirement rather than on its own initiative. For example, FHA's Home Equity Conversion Mortgage insurance program started as a pilot that authorized FHA to insure 2,500 reverse mortgages.[12] Additionally, some mortgage institutions may limit the origination and servicing of new products to their better lenders and servicers. Fannie Mae and Freddie Mac both reported that these were important steps in introducing a new product.

We recommended that when FHA releases new products or makes significant changes to existing products, it consider similar steps to limit the initial availability of these products. FHA officials agreed that they could, under certain circumstances, envision piloting or limiting the ways in which a new product would be available, but pointed to the practical limitations of doing so. For example, FHA officials told us that administering the Home Equity Conversion Mortgage pilot program was difficult because of the challenges of equitably selecting a limited number of lenders and borrowers. FHA generally offers products on a national basis and, if they did not, specific regions of the county or lenders might question why they were not able to receive the same benefit. FHA officials told us they have conducted pilot programs when Congress has authorized them, but they questioned the circumstances under which pilot programs were needed, and also said that they lacked sufficient resources to appropriately manage a pilot. Consistent with these views, FHA officials told us more recently that they would not limit the initial availability of any products authorized by its legislative proposal. However, if FHA does not limit the availability of new or changed products, the agency runs the risk of facing higher claims from products whose risks may not be well understood.

THE WAY FHA DEVELOPED TOTAL LIMITS THE SCORECARD'S EFFECTIVENESS IN ASSESSING THE DEFAULT RISK OF BORROWERS

A primary tool that FHA uses to assess the default risk of borrowers who apply for FHA-insured mortgages is its TOTAL scorecard. TOTAL's capabilities are important, because to the extent that conventional mortgage lenders and insurers are better able than FHA to use mortgage scoring to identify and approve relatively low-risk borrowers and charge fees based on default risk, FHA may face adverse selection. That is, conventional providers may approve lower-risk borrowers in FHA's traditional market segment, leaving relatively high-risk borrowers for FHA. Accordingly, the greater the effectiveness of TOTAL, the greater the likelihood that FHA will be able to effectively manage the risks posed by borrowers and operate in a financially sound manner.

In reports we issued in November 2005 and April 2006, we noted that while FHA's process for developing TOTAL generally was reasonable, some of the choices FHA made in the development process could limit the scorecard's effectiveness.[13] FHA and its contractor used variables that reflected borrower and loan characteristics to create TOTAL, as well as an accepted modeling process to test the variables' accuracy in predicting default. However, we also found that:

The data used to develop TOTAL were 12 years old by the time FHA implemented the scorecard. Specifically, when FHA began developing TOTAL in 1998, the agency chose to use 1992 loan data, which would be old enough to provide a sufficient number of defaults that could be attributed to a borrower's poor creditworthiness. However, FHA did not implement TOTAL until 2004 and has not subsequently updated the data used in the scorecard. Best practices of private-sector organizations call for scorecards to be based on data that are representative of the current mortgage market—specifically, relevant data that are no more than several years old. In the past 12 years, significant changes—growth in the use of down-payment assistance, for example—have occurred in the mortgage market that have affected the characteristics of those applying for FHA-insured loans. As a result, the relationships between borrower and loan characteristics and the likelihood of default also may have changed.

TOTAL does not include certain key variables that could help explain expected loan performance. For example, TOTAL does not include a variable for the source of the down payment. However, FHA contractors, HUD's Inspector General, and our work have all identified the source of a down payment as an important indicator of risk, and the use of down-payment assistance in the FHA program has grown rapidly over the last 5 years. Further, TOTAL does not include other important

[12] Under this program, homeowners borrow against equity in their home and receive payments from their lenders.

[13] GAO, Mortgage Financing: HUD Could Realize Additional Benefits from its Mortgage Scorecard, GAO–06–435 (Washington, DC: Apr. 13, 2006) and GAO–06–24.

variables—such as a variable for generally riskier adjustable rate loans—included in other scorecards used by private-sector entities.

Although FHA had a contract to update TOTAL, the agency did not develop a formal plan for updating TOTAL on a regular basis. Best practices in the private sector, also reflected in bank regulator guidance, call for having formal policies to ensure that scorecards are routinely updated. Without policies and procedures for routinely updating TOTAL, the scorecard may become less reliable and, therefore, less effective at predicting the likelihood of default.

To improve TOTAL's effectiveness, we recommended, among other things, that HUD develop policies and procedures for regularly updating TOTAL and more fully consider the risks posed by down-payment assistance when underwriting loans, such as including the presence and source of down-payment assistance as a loan variable in the scorecard. In response, FHA has developed and begun putting in place policies and procedures that call for annual: (1) monitoring of the scorecard's ability to predict loan default; (2) testing of additional predictive variables to include in the scorecard; and, (3) updating the scorecard with recent loan performance data.

We also recommended that HUD explore additional uses for TOTAL, including using it to implement risk-based pricing of mortgage insurance and to develop new products. These actions could enhance FHA's ability to effectively compete in the mortgage market and avoid adverse selection. Our ongoing work indicates that FHA plans to use borrowers' TOTAL scores to help set insurance premiums. Accordingly, any limitations in TOTAL's ability to predict defaults could result in FHA mispricing its products.

FHA'S CURRENT REESTIMATED SUBSIDY COSTS ARE GENERALLY LESS FAVORABLE THAN ITS ORIGINAL ESTIMATES

As previously noted, FHA, like other Federal agencies, is required to reestimate credit subsidy costs annually to reflect actual loan performance and expected changes in estimates of future loan performance. In doing so, FHA reestimates subsidy costs for each loan cohort.

As we reported in September 2005, FHA's subsidy reestimates generally have been less favorable (i.e., higher) than the original estimates since Federal credit reform became effective in 1992.[14] The current reestimated subsidy costs for all except the fiscal year 1992 and 1993 cohorts are higher than the original estimates. For example, the current reestimated cost for the fiscal year 2006 cohort is about $800 million less favorable than originally estimated.

With respect to reestimates across cohorts, our report examined factors contributing to an unusually large $7 billion reestimate (more than twice the size of other recent reestimates) that FHA submitted as of the end of fiscal year 2003 for the fiscal year 1992 through 2003 cohorts. These factors included increases in estimated claims and prepayments (the payment of a loan before its maturity date). Several policy changes and trends may have contributed to changes in the expected claims. For example:

Revised underwriting guidelines made it easier for borrowers who were more susceptible to changes in economic conditions—and therefore more likely to default on their mortgages—to obtain an FHA-insured loan.

Competition from conventional mortgage providers could have resulted in FHA insuring more risky borrowers.

FHA insured an increasing number of loans with down-payment assistance, which generally have a greater risk of default.

FHA's loan performance models did not include key variables that help estimate loan performance, such as credit scores, and as of September 2005, the source of down payment.

The major factors underlying the surge in prepayment activity were declining interest rates and rapid appreciation of housing prices. These trends created incentives and opportunities for borrowers to refinance using conventional loans.

To more reliably estimate program costs, we recommended that FHA study and report on how variables found to influence credit risk, such as payment-to-income ratios, credit scores, and down-payment assistance would affect the forecasting ability of its loan performance models. We also recommended that when changing the definitions of key variables, FHA report the impact of such changes on the models' forecasting ability. In response, HUD indicated that its contractor was considering the specific variables that we had recommended FHA include in its annual actuarial review of the Fund. The contractor subsequently incorporated the source of down-

[14] GAO, Mortgage Financing: FHA's $7 Billion Reestimate Reflects Higher Claims and Changing Loan Performance Estimates, GAO–05–875 (Washington, DC: Sep. 2, 2005).

payment assistance in the fiscal year 2005 actuarial review and borrower credit scores in the fiscal year 2006 review.

Madam Chairman, this concludes my prepared statement. I would be happy to answer any questions at this time.

Senator MURRAY. Thank you very much. Ms. Poole.

STATEMENT OF JOANNE POOLE, COMMITTEE LIAISON, NATIONAL ASSOCIATION OF REALTORS

Ms. POOLE. Good morning, Madam Chairman and Ranking Member Bond and members of the subcommittee. I am the broker/owner of Poole Realty, located in Glen Burnie, Maryland. I have been a realtor for 21—sorry.

I am the broker/owner of Poole Realty in Glen Burnie, Maryland and I have been a realtor for 21 years and I am currently part of the National Association of Realtors' Enlarged Leadership Team. I am here today to present the views of the National Association of Realtors' 1.3 million realtor members on the need to reform the FHA program.

The current increase in foreclosures is troubling to all of us. Predatory lending, exotic mortgages and a dramatic rise in subprime lending, coupled with the slowing of the home price appreciation, have all contributed to this crisis.

In 1934, the Federal Housing Administration was established to provide consumers an alternative during a similar lending crisis. At that time, short term, interest only and balloon loans were prevalent. As conventional and subprime lenders have expanded their repertoire of loan products, FHA has remained stagnant. As a result, a growing number of homebuyers have turned to subprime and nontraditional mortgages. While subprime loans have a very important role for certain borrowers, there are many consumers who have taken out subprime loans when they would have easily qualified for FHA at a lower overall cost.

More troubling are the families who have explored nontraditional mortgages such as interest-only and option ARMs. For some of these borrowers, monthly payments will become impossible as payments increase by as much as 50 percent or more when the introductory periods end or when their loan balances get larger and larger each month instead of smaller.

To enhance FHA's viability, the administration has proposed a number of important reforms to the FHA Single Family Insurance program that NAR believes will greatly benefit homebuyers by improving access to FHA's safe and affordable credit.

As an example, the National Association of Realtors projects that in Washington State, where less than 6,500 homeowners used FHA for financing in 2005, the reforms proposed could increase the number of FHA homebuyers by more than 62 percent, saving those borrowers $20.9 million over what they would have paid with a subprime loan. Also based on NAR's research, we believe that in Missouri, the FHA borrowers would have increased by 50 percent for a savings of $18.1 million.

Eliminating the statutory 3 percent minimum cash investment in down payment calculation will provide consumers a safe option away from the nontraditional products. Differing premiums based on the risk of the borrower, would allow FHA a balanced risk. Risk based pricing is accepted practice in the private market; it should be for FHA as well.

The administration also proposes combining all Single Family programs into the Mutual Mortgage Insurance fund. It simply makes good business sense to combine these programs. The administration also proposes increasing FHA's loan limits, not in just high cost areas but nationwide. Such increases are critical to FHA to assist homebuyers in places like California but also areas where home prices exceed the current maximum of $200,160 but are not defined as high cost areas, such as Washington, Pennsylvania and Colorado.

The universal and consistent availability of FHA loan products is the principle hallmark of the program that has made mortgage insurance available to individuals regardless of their racial, ethnic or social characteristics during periods of economic prosperity and economic depression. This will be especially important today.

By offering access to prime rate financing, FHA provides borrowers a means to achieve lower monthly payments without relying on interest only or optional payment schemes. FHA products are fairly priced without resorting to teaser rates or negative amortization but provides safe and appropriate underwriting and loss mitigation programs.

FHA's loss mitigation program authorizes lenders to assist borrowers in default. In the year 2004 alone, more than 78,000 borrowers were able to retain their home through FHA's loss mitigation program and 2 years later, nearly 90 percent of those borrowers are still in their homes.

By encouraging lenders to participate in loss mitigation efforts and penalizing those who don't, FHA has successfully helped homeowners keep their homes and reduce the level of losses to FHA fraud.

PREPARED STATEMENT

FHA is often criticized—yes. Without the reforms to the FHA program first time homebuyers, minorities and homebuyers with less than perfect credit will continue to see fewer and fewer safe, affordable mortgage options. The National Association of Realtors really believe that this is a program that needs to be revamped and have partnered with the Federal Housing Administration to produce a booklet, which I would ask be admitted into testimony, FHA Improvement Benefits to You and the Homeowner.

[The information follows:]

PREPARED STATEMENT OF JOANNE POOLE

Madam Chairman, Ranking Member Bond, thank you for this opportunity to testify before you. My name is JoAnne Poole and I am the broker/owner of Poole Realty in Glen Burnie, Maryland. I have been a realtor for 21 years, and am currently part of NAR's Enlarged Leadership Team, and serve as a 2007 Liaison.

I am here to testify on behalf of 1.3 million members of the National Association of REALTORS®. We thank you for the opportunity to present our view on the FHA program and the need for reform. NAR represents a wide variety of housing industry professionals committed to the development and preservation of the Nation's housing stock and making it available to the widest range of potential homebuyers. The Association has a long tradition of support for innovative and effective Federal housing programs and we have worked diligently with the Congress to fashion housing policies that ensure Federal housing programs meet their mission responsibly and efficiently.

NEED FOR FHA

The current increase in foreclosures is troubling to all of us. In 2006, 1.2 million families entered into foreclosure, 42 percent more than in 2005.[1] Predatory lending, exotic mortgages and a dramatic rise in sub-prime lending—coupled with slowing home price appreciation—have all contributed to this crisis.

In 1934 the Federal Housing Administration was established to provide consumers an alternative during a similar lending crisis. At that time, short-term, interest-only and balloon loans were prevalent. Since its inception, FHA has insured more than 34 million properties. However, because it hasn't evolved, FHA's market share has been dropping. In the 1990's FHA loans were about 12 percent of the market. Today, that rate is less than 3 percent. This statistic is unfortunate given that FHA is needed now as much as it was in 1934. At the same time, the sub-prime market has skyrocketed. In 2003, the sub-prime market share was 8.5 percent by 2005 it was at 20 percent. In 2006, FHA/VA market share dropped 37.8 percent; conventional loans dropped 9.8 percent; while sub-prime loans increased another 15.7 percent.

When formed, FHA was a pioneer of mortgage products. FHA was the first to offer 30-year fixed-rate financing in a time when loans were generally for less than 5 years. Unfortunately, FHA has not changed with the times. Where they were once the innovator, FHA has become the lender of last resort. As conventional and sub-prime lenders have expanded their repertoire of loan products, FHA has remained stagnant. As a result, a growing number of homebuyers are deciding to use one of several new types of non-traditional mortgages that let them "stretch" their income so they can qualify for a larger loan.

Non-traditional mortgages often begin with a low introductory interest rate and payment—a "teaser"—but the monthly mortgage payments are likely to increase significantly in the future. Some of these loans are "low documentation" mortgages that provide easier standards for qualifying, but also feature higher interest rates or higher fees. Mortgages such as interest-only and option ARMs can often be risky propositions for some borrowers. These products pose severe risk for consumers who may be unable to afford their mortgage payments when monthly payments increase by as much as 50 percent or more when the introductory periods end, or when their loan balances get larger each month instead of smaller. Mortgage experts estimate that approximately $1.5 trillion worth of adjustable mortgages will reset by the end of 2007.[2] While some borrowers may be able to make the new higher payments, many will find it difficult, if not impossible.

As the market has changed, FHA must also change to reflect consumer needs and demands. If FHA is enhanced to conform to today's mortgage environment, many borrowers would have available to them a safer alternative to the riskier products that are currently marketed to them.

FHA REFORM PROPOSALS

To enhance FHA's viability, the administration has proposed a number of important reforms to the FHA single-family insurance program that NAR believes will greatly benefit homebuyers by improving access to FHA's safe and affordable credit. By way of an example, NAR projects that in Washington State, where less than 6,500 homeowners used FHA for financing in 2005, the reforms proposed could increase the number of FHA homebuyers by more than 62 percent, saving those borrowers $20.9 million over what they would pay for a sub-prime loan.

FHA is proposing to eliminate the statutory 3 percent minimum cash investment and downpayment calculation, allow FHA flexibility to provide risk-based pricing, move the condo program into the 203(b) fund, and increase the loan limits. The National Association of REALTORS® strongly supports these reform provisions.

Down Payment Flexibility.—The ability to afford the downpayment and settlement costs associated with buying a home remains the most challenging hurdle for many homebuyers. Eliminating the statutory 3 percent minimum downpayment will provide FHA flexibility to offer varying downpayment terms to different borrowers. Although housing remains strong in our Nation's economy and has helped to increase our Nation's homeownership rate to a record 69 percent, many deserving American families continue to face obstacles in their quest for the American dream of owning

[1] A Flood of Foreclosures, But Should You Invest?, Market Watch, February 18, 2007.
[2] Homeowners Brace For ARMs' New Rates, The Seattle Times, February 17, 2007.

a home. Providing flexible downpayment products for FHA will go a long way to addressing this problem.

In 2005, 43 percent of first-time homebuyers financed 100 percent of their home. NAR research indicates that if FHA were allowed to offer this option, 1.6 million families could benefit. According to NAR's Profile of Homebuyers, 55 percent of homebuyers who financed with a zero-downpayment loan in 2005, had incomes less than $65,000; 24 percent of those who used a zero-downpayment product were minorities; and 52 percent of people who financed 100 percent of their home purchased homes priced at less than $150,000. It is important to note that FHA will require borrowers to have some cash investment in the home. This investment can be in the form of payment of the up-front premium or closing costs. No loan will be made for more than 103 percent the value of the home.

Loan Limits.—FHA mortgages are used most often by first-time homebuyers, minority buyers, and other buyers who cannot qualify for conventional mortgages because they are unable to meet the lender's stringent underwriting standards. Despite its successes as a homeownership tool, FHA is not a useful product in high cost areas of the country because its maximum mortgage limits have lagged far behind the median home price in many communities. As a result, working families such as teachers, police officers and firefighters are unable to buy a home in the communities where they work. Even in your home State of Washington, Madam Chairman, the median home price exceeds FHA's current limit of $200,160.

This is why NAR strongly supports proposals to change the FHA loan limits. Under the administration's plan, FHA's limits for single unit homes in high cost areas would increase from $362,790 to the 2006 conforming loan limit of $417,000. In non-high cost areas, the FHA limit (floor) would increase from $200,160 to $271,050 for single unit homes. This increase will enhance FHA's ability to assist homebuyers in areas not defined as high-cost, but where home prices still exceed the current maximum of $200,160. This includes States like Arizona, Colorado, Florida, Georgia, Illinois, Maine, Minnesota, Nevada, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, and Washington. While none of these States is generally considered "high cost", all have median home prices higher than the current FHA loan limit.

Risk-based Pricing.—Another key component of the administration's proposal is to provide FHA with the ability to charge borrowers different premiums based on differing credit scores and payment histories. Risk-based pricing of the interest rate, fees and/or mortgage insurance is used in the conventional and sub-prime markets to manage risk and appropriately price products based on an individual's financial circumstances. Currently, all FHA borrowers, regardless of risk, pay virtually the same premiums and receive the same interest rate.

The legislation will allow FHA to differentiate premiums based on the risk of the product (e.g. amount of cash investment) and the credit profile of the borrower. These changes will enable FHA to offer all borrowers choices in the type of premium charged (e.g. annual, upfront or a hybrid). In addition it will permit FHA to reach higher risk borrowers (by charging them a premium amount commensurate with risk), while continuing to attract the better credit risks, by charging them less. FHA financing, with risk-based premium pricing, will still be a much better deal for borrowers with higher risk characteristics than is currently available in the "near prime" or sub-prime markets. Risk-based pricing makes total sense to the private market, and should for FHA as well.

It is also important to note that, while FHA has had the authority to charge premiums up to 2.25 percent, they have not done so. FHA currently charges 1.5 percent. The FHA Fund is strong and has continued to have excess revenue, so there has not been a need to increase the premiums. However, due to its markedly decreased market share, FHA may have to increase premiums on borrowers in 2007 and in future years. Unless the program is reformed to make it more consumer-friendly, FHA will need to generate more revenue to cover its losses.

Giving FHA the flexibility to charge different borrowers different premiums based on risk will allow FHA to increase their pool of borrowers. If FHA is also given authority to provide lower downpayment mortgages, premium levels will need to reflect the added risk of such loans (as is done in the private market) to protect the FHA fund.

Changes to the Fund Structures.—The administration also proposes to combine all single-family programs into the Mutual Mortgage Insurance Fund. The FHA program has four funds with which it insures its mortgages. The Mutual Mortgage Insurance (MMI) Fund is the principal funding account that insures traditional section 203b single-family mortgages. The Fund receives upfront and annual premiums collected from borrowers as well as net proceeds from the sale of foreclosed homes. It is self-sufficient and has not required taxpayer bailouts.

The Cooperative Management Housing Insurance Fund (CMHI), which is linked to the MMI Fund, finances the Cooperative Housing Insurance program (section 213) which provides mortgage insurance for cooperative housing projects of more than 5 units that are occupied by members of a cooperative housing corporation.

FHA also operates Special Risk Insurance (SRI) and General Insurance (GI) Funds, insuring loans used for the development, construction, rehabilitation, purchase, and refinancing of multifamily housing and healthcare facilities as well as loans for disaster victims, cooperatives and seniors housing. Currently, the FHA condominium loan guarantee program and 203k purchase/rehabilitation loan guarantee program are operated under the GI/SRI Fund.

NAR strongly supports inclusion of the FHA condominium loan guarantee program and the 203k purchase/rehabilitation loan guarantee program in the MMIF. Both of these programs provide financing for single family units and have little in common with multifamily and health facilitates programs covered by the SRI and GI funds. In recent years programs operating under the GI/SRI funds have experienced disruptions and suspensions due to funding commitment limitations. Maintaining the single family condo and purchase/rehabilitation programs under the GI/SRI funds exposes these programs to possible future disruptions. Thus, from a conceptual an accounting standpoint, it makes sound business sense to place all single-family programs under the MMIF.

Program Enhancements.—As well as combining the 203(k) and condominium programs under the MMIF, NAR also recommends key enhancements to increase the programs' appeal and viability. Specifically, NAR recommends that HUD be directed to restore investor participation in the 203(k) program. In blighted areas, homeowners are often wary of the burdens associated with buying and rehabilitating a home themselves. However, investors are often better equipped and prepared to handle the responsibilities related to renovating and repairing homes. Investors can be very helpful in revitalizing areas where homeowners are nervous about taking on such a project.

We also recommend that HUD lift the current owner-occupied requirement of 51 percent before individual condominium units can qualify for FHA-insured mortgages. The policy is too restrictive because it limits sales and homeownership opportunities, particularly in market areas comprised of significant condominium developments and first-time homebuyers. In addition, the inspection requirements on condominiums are burdensome. HUD has indicated that it would provide more flexibility to the condo program under the MMIF. We strongly support loosening restrictions on FHA condo sales and 203k loans to provide more housing opportunities to homebuyers nationwide.

BORROWER BENEFITS OF FHA

The universal and consistent availability of FHA loan products is the principal hallmark of the program that has made mortgage insurance available to individuals regardless of their racial, ethnic, or social characteristics during periods of economic prosperity and economic depression.

The FHA program makes it possible for higher-risk, yet credit-worthy borrowers to get prime financing. According to a recent Federal Reserve Bank review,[3] the average credit score for sub-prime borrowers was 651. This is higher than FHA's median credit score borrower, which demonstrates that these borrowers are likely paying more than they need to pay. By offering access to prime rate financing, FHA provides borrowers a means to achieve lower monthly payments—without relying to interest-only or "optional" payment schemes. FHA products are safe, thanks to appropriate underwriting and loss-mitigation programs, and fairly priced without resorting to teaser rates or negative amortization.

When the housing market was in turmoil during the 1980s, FHA continued to insure loans when others left the market; following 9/11, FHA devised a special loan forbearance program for those who temporarily lost their jobs due to the attack; after Hurricanes Katrina and Rita, FHA provided a foreclosure moratorium for borrowers who were unable to pay their mortgages while recovering from the disaster. FHA's universal availability has helped to stabilize housing markets when private mortgage insurance has been nonexistent or regional economies have faltered. FHA is the only national mortgage insurance program that provides financing to all markets at all times. Simply put, FHA has been there for borrowers.

Now, more than ever, FHA needs to be strengthened to continue to be available to borrowers. In just the past few months, at least 25 sub-prime lenders have exited the business, declared bankruptcy, announced significant losses, or put themselves

[3] Federal Reserve Bank of St. Louis Review—January-February 2006.

up for sale.[4] After making record profits, these lenders are simply bailing as the bad loans they made begin to fail. FHA, who is more careful with its underwriting standards, can be a safe alternative for buyers who have been lured into unnecessary sub-prime loans.

FHA is a leader in preventing foreclosures. FHA's loss mitigation program authorizes lenders to assist borrowers in default. The program includes mortgage modification and partial claim options. Mortgage modification allows borrowers to change the terms of their mortgage so that they can afford to stay in the home. Changes can include extension of the length of the mortgage or changes in the interest rate. Under the partial claim program, FHA lends the borrower money to cure the loan default. This no-interest loan is not due until the property is sold or paid off. In the year 2004 alone, more than 78,000 borrowers were able to retain their home through FHA's loss mitigation program; and 2 years later, nearly 90 percent of these borrowers are still in their homes. By encouraging lenders to participate in these loss mitigation efforts and penalizing those who don't, FHA has successfully helped homeowners keep their homes and reduced the level of losses to the FHA fund.

SOLVENCY AND STRENGTH OF FHA

Critics of the reform proposals have argued that FHA isn't positioned to handle changes to the program. We respectfully disagree. Despite FHA's falling market share, the FHA fund is healthy and strong. Congress has mandated that FHA have a capitalization ratio of 2 percent to insure fiscal solvency. In 2006, the FHA cap ratio was far above that figure at 6.82 percent—despite being the lender of last resort in today's marketplace. FHA's current economic value is over $22 billion. In simple terms, this indicates that if the MMIF stopped operations today, the current portfolio would be expected to generate $22 billion dollars over the remaining life of the loans in the portfolio above what it would pay out in claims. Since its inception in 1934, FHA has never needed a Federal bailout, and has been completely self-sufficient. In fact, FHA has contributed a significant amount of money to the Federal Treasury each year. However, due to the dramatic loss in volume, FHA has estimated that it will need to increase premiums if reforms are not implemented that increase usage of FHA.

If FHA is allowed to adjust premiums based on risk, it will operate even more soundly than it does today. If FHA is to thrive and fully perform its intended function, a change to risk-based pricing is necessary. Average pricing in the portion of the credit spectrum where FHA operates is crucial if FHA is to sustain its operations in a financially solvent manner. Absent risk-based premiums, the risk profile FHA borrowers can decrease, causing either an increase in the average price or an ultimate shortfall in the insurance fund. This is why FHA has estimated that it will need to increase premiums if reforms are not implemented that increase usage of FHA.

FHA is often criticized for its default and foreclosure rate. That criticism is unwarranted, as FHA's mission is to serve people that aren't served by the conventional market, and therefore are more risky. However, FHA's foreclosure rate is substantially better than the sub-prime market, where many FHA-eligible borrowers currently have loans. A recent study by the Center for Responsible Lender reported that "FHA and sub-prime loans have quite different foreclosure rates. For example, sub-prime loans originated in 2000 in our sample had a 12.9 percent foreclosure rate within 5 years. In contrast, . . . FHA loans originated in 2000 had a 6.29 percent foreclosure rate by year-end 2005."[5]

When FHA has seen problems with their default rates, they have tried to remedy them. FHA noticed that loans which utilized a gift downpayment had a higher default rate. These gifts included seller-funded downpayment assistance. FHA attempted to eliminate this program and faced legal challenges. At that time Congress supported downpayment gift providers, and challenged HUD's attempt to shut them down. Studies done by the Government Accountability Office and others determined that this form of downpayment assistance in fact drove up the costs of homeownership, and generally made the loan a bigger risk. Although the IRS recently ruled that many seller-funded downpayment programs would lose their charitable tax status, they have yet to change the status of any organization. To avoid further delay, FHA announced plans to publish a notice prohibiting gift downpayment loans from FHA eligibility. Such a prohibition should greatly improve FHA's default rate. It has

[4] The Mortgage Mess Spreads, BusinessWeek.com, March 7, 2007.

[5] Losing Ground:Foreclosures in the Subprime Market and Their Cost to Homeowners, Center for Responsible Lending, December 2006, page 26.

been estimated that 29 percent of FHA borrowers in 2005 used seller-funded downpayment assistance.

Instead, by providing FHA the ability to offer flexible down payments, homeowners won't bear the increased home price costs and the loans will be safer. Allowing FHA to price low downpayment loans according to risk, they would be more in line with the conventional market. This will greatly increase FHA's default rate.

Furthermore, FHA's operations have improved dramatically in the last several years. In 1994, HUD was designated as "high risk" by the Government Accountability Office, a longtime critic of the Department. Last month, that designation was removed. GAO said that "HUD had improved its oversight of lenders and appraisers and issues or proposed regulations to strengthen lender accountability and combat predatory lending practices."[6] HUD has also demonstrated their ability to estimate program costs and oversight for mortgage underwriting.

CONCLUSION

Thank you again for the opportunity to testify on this important issue. Now is the time when the country needs FHA. As sub-prime loans reset and real estate markets are no longer experiencing double digit appreciation; a reformed FHA would be perfectly positioned to offer borrowers a safer mortgage alternative and bring stability to local markets and local economies. The National Association of REALTORS® stands ready to work with the Congress on passage of FHA reform.

ATTACHMENT 1.—FHA BROCHURE

SHOPPING FOR A MORTGAGE? FHA IMPROVEMENTS BENEFIT YOU

FHA Insured Mortgages

Realtors® and FHA: Partners in Homeownership

REALTORS® AND FHA—WORKING TOGETHER TO HELP PEOPLE FULFILL THE AMERICAN DREAM

REALTORS® and the Federal Housing Administration (FHA), which is part of the U.S. Department of Housing and Urban Development (HUD), have been partners in creating homeownership opportunities for more than 70 years. Since FHA was created in 1934, it has helped more than 34 million families become homeowners, many by working with their REALTORS® to achieve their dream of homeownership.

This brochure illustrates improvements in FHA programs that will benefit you. Many aspects of the FHA mortgage application process have been streamlined to make the process more user-friendly and efficient. Upon reading this brochure, you will see that FHA programs are a valuable asset to REALTORS®, other real estate professionals, and most importantly, those seeking to own a home.

Backed by the full faith and credit of the Federal government, FHA-insured mortgages are one of the safest and most affordable types of mortgages available to homebuyers. Working together, REALTORS® and FHA help millions of families come home.

WHAT IS FHA MORTGAGE INSURANCE?

The Federal Housing Administration (FHA) insures mortgages offered by banks, savings associations, and other financial institutions. An FHA-insured mortgage is backed by the full faith and credit of the United States government. While FHA does not make loans, it benefits the homebuyer by providing mortgage insurance which encourages financial institutions to make affordable financing available.

WHAT ARE THE BENEFITS OF AN FHA MORTGAGE?

FHA offers low down payment options, eligibility with less than perfect credit, a loan at a reasonable cost, and help if there is ever trouble making the mortgage payment. Because an FHA mortgage insures the lender against loss, an FHA mortgage typically has an interest rate that is competitive with the best in your market and lower than the rates charged for subprime and other non-prime mortgages.

FHA not only helps people buy a home, but helps them keep it as well. In return for protecting lenders against loss, FHA requires financial institutions to offer assistance to borrowers experiencing difficulty making mortgage payments.

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[6] GAO, High Risk Series: An Update, GAO–07–310 (Washington, DC.: January, 2007)

WHAT ABOUT ELIGIBILITY?

In order to be eligible for an FHA-insured mortgage, a borrower must:
—Occupy the property as the principal residence;
—Possess a valid Social Security Number;
—Have a two-year employment history;
 —School and military service count towards this two-year requirement.
—Not be delinquent on any Federal debt such as a student loan or other FHA-insured mortgage; and
—Meet flexible credit requirements.

THERE ARE SEVERAL OTHER FEATURES WORTH KNOWING ABOUT AN FHA-INSURED MORTGAGE:

—FHA adopted the industry appraisal standards permitting the use of the Fannie Mae appraisal forms with no additional specialized documentation, no Valuation Conditions form or Homebuyer Summary.
—FHA has eliminated unnecessary requirements to make minor repairs.
—The homebuyer and the seller, individually or jointly, can pay closing costs as agreed to in the sales contract. FHA no longer limits what closing costs the homebuyer is permitted to pay.
—Caps on payment and debt-to-income ratios are more generous than most standard conforming mortgage products. The payment-to-income ratio may not exceed 31 percent and the debt-to-income ratio may not exceed 43 percent.
—A minimum credit score is not required. In fact, one may not be turned down for an FHA mortgage solely for lack of credit history.
—The buyer's entire cash investment—as little as three percent—can be a gift from a family member, employer, charitable organization or local government entity.
—The seller can contribute up to 6 percent of the home's price toward closing costs through a seller's concession.
—There are no prepayment penalties on FHA-insured mortgages.
—U.S. citizenship is not required but, for those who are not citizens, they must be lawful permanent or non-permanent resident aliens with a valid Social Security Number.

HOW ELSE CAN FHA ASSIST IN ACHIEVING HOMEOWNERSHIP?

In addition to its standard Section 203(b) Mortgage Insurance Program, FHA has a number of other valuable programs designed to facilitate homeownership.

FHA Adjustable Rate Mortgage (ARM) Products

—FHA offers a standard 1-year adjustable rate mortgage (ARM) as well as 3, 5, 7, and 10-year ARM options.
—ARM products may be good options for those who plan to own the home for only a few years, expect an increase in future earnings, or expect a decrease in interest rates.

FHA's Limited Repair Program

—FHA's Section 203(k) Limited Repair Program is an excellent financing option for you whether buying or selling homes—especially when repairs are identified during a home inspection or appraisal—because it gives buyers the ability to make repairs after closing.
—Buyers can finance up to an additional $35,000 into their mortgage to pay for minor remodeling such as replacing flooring, installing new appliances, and painting the interior and/or exterior of the home.

IN ADDITION TO FHA, THE U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT (HUD) OFFERS THESE RESOURCES:

HUD Homes

The Department has single-family homes in hundreds of communities available for sale to the public. How do you benefit from purchasing a HUD Home?
—Many HUD homes are available with FHA financing, making it easier to purchase a home.
—The Department pays the real estate commission, if it is included in the contract.
—Only a real estate professional licensed by the state and registered with HUD can sell HUD homes.

For more information on available HUD homes, please visit: www.homesales.gov.

For more information on selling HUD homes, please visit: www.hud.gov/groups/brokers.cfm.

HUD-Approved Housing Counseling Agencies

Homebuyers often have a lot of questions about getting an FHA-insured mortgage and about the home buying process in general. HUD-approved Housing Counseling Agencies provide buyers the opportunity to get the answers they need by meeting with a housing counselor at a HUD-approved agency in their community. These agencies offer homeownership counseling and financial literacy training at little or no cost. To find a counselor in your neighborhood, call 1–800–569–4287 or visit http://www.hud.gov/buying/index.cfm and click on "find a housing counselor" on the right under "counseling and education."

To learn more about these products or to find out if there are homeownership programs sponsored by your state or local governments and other community organizations, please visit FHA's website at www.fha.gov or call 1.800 CALL FHA.

For more information about the National Association of REALTORS® and how we work with you, visit our website at www.REALTOR.org.

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, representing more than 1.3 million members involved in all aspects of the residential and commercial real estate industries. For more information, please visit www.REALTOR.org.

The Federal Housing Administration (FHA)—which is part of the U.S. Department of Housing and Urban Development—has been helping people become homeowners since 1934. FHA insures the loan, so lenders can offer you a better deal. FHA offers loans with low down payments that are easier to qualify for, and can cost less than conventional loans. For more information, please visit www.fha.gov.

October 2006, Item# 126–128. National Association of REALTORS®, 500 New Jersey Avenue, NW, Washington, DC, 20001. Federal Housing Administration, U.S. Department of Housing and Urban Development, 451 7th Street, SW, Washington, DC, 20410.

Senator MURRAY. Thank you very much. Mr. Robbins.

STATEMENT OF JOHN M. ROBBINS, CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Mr. ROBBINS. Good morning, Chairwoman Murray and Ranking Member Bond. Thank you for holding this hearing and inviting me to share MBA's views on reforming the FHA.

I have spent over 36 years working with FHA and I have made billions of dollars in loan originations to families who have achieved the dream of home ownership through FHA's programs. When I started in the mortgage business, FHA programs helped us serve many borrowers who otherwise would not get a loan.

Today, the story is very different. In 2003, FHA made up approximately 16 percent of my company's overall production. Last year, only a little more than 1 percent of our business went to FHA.

While the mortgage market has grown significantly, our use of the FHA program has dropped precipitously. Lenders have progressed, reacting to quickly changing and efficient technology. Unfortunately, FHA has not. While the needs of low-and-moderate income homebuyers, first time homebuyers and of senior homeowners have changed, FHA has not followed its historic path of adopting to meet borrowers' changing needs.

MBA strongly supports FHA and believes it still plays a critical role in today's marketplace. Most of FHA's business is directed toward low-and-moderate income and minority borrowers, the very strata that is most challenged to be part of the American dream. At the same time, we have watched with growing concern as FHA has steadily lost market share over the past decade, potentially threatening its long-term ability to help underserved borrowers.

As the market continues to evolve around FHA, the great fear is that many aspiring homeowners will either be left behind or forced into higher cost alternatives.

MBA notes with great concern that the administration's fiscal year 2008 budget proposal estimates the FHA Mortgage Insurance Fund will go into the red next year unless changes to the existing program are made or additional appropriations are provided. MBA agrees with the administration that FHA's Mutual Mortgage Insurance Fund would run in the black with little or no premium increase necessary if FHA reform proposals were passed this year.

In fact, in casual calculation—back of the envelope—not at this point supported by MBA institutional research, I suggest if FHA were to regain its market share back to its 1990 level of 10 percent, the U.S. Treasury would receive an additional $3 billion a year in revenue from expanded use of this program. We believe Congress should empower FHA to allow it to meet today's needs and anticipate tomorrow's.

MBA believes changes should be made in three areas. FHA needs more flexibility to introduce innovative new products, invest in new technology and manage their human resources. MBA supports changes to FHA's loan limits. FHA's down payment requirements, including the elimination of the complicated down payment formula and down payment flexibility. The down payment is one of the primary obstacles for first-time minority and low-income borrowers.

Finally, MBA also supports changes to the Home Equity Conversion Mortgage Program. MBA's surveys show that FHA's hack' em-up product comprises 95 percent of all reverse mortgages and is thus, tremendously important for our senior homeowners.

In conclusion, FHA has an important role to play in the market, in the expanding, affordable home ownership opportunities for the underserved and addressing the home ownership gap. For low-and-moderate income families, FHA should be the financing considered first because it has the lowest rate and provides borrowers the best opportunity to become a successful homeowner.

PREPARED STATEMENT

However, the current loss of market presence means we are losing FHA's impact. The result is that some families are either turning to more expensive financing or giving up. I urge Congress to enact legislation to reform FHA, to increase its availability to homebuyers, promote consumer choice and ensure its ability to continue serving American families. MBA stands ready to work with you on this important issue.

[The statement follows:]

PREPARED STATEMENT OF JOHN M. ROBBINS

Thank you for holding this hearing and inviting the Mortgage Bankers Association (MBA)[1] to share its views with the subcommittee on the solvency and reform

[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 500,000 people in virtually every community in the country. Headquartered in Washington, DC, 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 member-

proposals for the Federal Housing Administration (FHA). My name is John Robbins and I am Co-Head and Special Counsel of American Mortgage Network, and Chairman of the Mortgage Bankers Association (MBA). Formerly, I was Chief Executive Officer of American Mortgage Network (AmNet), a wholesale mortgage bank I co-founded which is based in San Diego. AmNet was bought by Wachovia Bank in 2005. I am here today because MBA believes Congress must act to make important legislative changes to the National Housing Act if the Federal Housing Administration (FHA) is to continue to be a financially sound tool for lenders to use in serving the housing needs of American families who are unserved or underserved by conventional markets.

When I started in the mortgage business, the programs of FHA were invaluable in enabling us to serve families who otherwise would have no other affordable alternative for financing their home. I spent over 36 years working with FHA and have made millions of dollars in loan originations to families who have become homeowners as a result of FHA's programs. We worked hard to be a good partner with FHA in administering its programs and, together, FHA and AmNet enabled thousands of families to purchase their first home.

Today, though, the story is very different. While AmNet has grown significantly, our ability to use the FHA program has declined precipitously. In 2003, FHA made up approximately 16 percent of our overall production. Last year, however, only a little more than 1 percent of our business went to FHA.

While AmNet has been able to adapt to changes in the mortgage markets, FHA has been prevented from doing so. The needs of low- and moderate-income homebuyers, of first-time homebuyers, of minority homebuyers, and of senior homeowners have changed. FHA's programs though, have not followed their historic path of adaptation to meet these borrowers' changing needs.

The numbers are troublesome. In 1990, 13 percent of total originations in the United States were FHA-insured mortgages. Currently, that number has dropped to under 3 percent.[2] More importantly, in 1990, 28 percent of new home sales (which are typically a large first-time homebuyer market) were financed through programs at FHA or the Department of Veterans Affairs (VA); today that number has dropped to under 12 percent.

MBA cites these numbers not because we believe that there is a certain market share that FHA should retain, but rather because these numbers are consistent with many lenders' views that FHA has not kept up with changes in the market. These numbers point to a decline, not just in market share, but in FHA's potential to positively impact homeownership. This loss of impact does not stem from the fact that FHA is no longer relevant, but rather that statutory constraints prohibit FHA from adapting its relevance to consumer needs today.

A recent anecdote illustrates this point very well. A story ran in RealtyTimes® almost 2 years ago, on June 21, 2005, in which a Baltimore, MD real estate agent unabashedly advises homebuyers to avoid FHA financing. The agent states: "Approved FHA loan recipients, same notice to you, don't bother bringing it to the table during a sellers market. More times than not, your offer will be rejected. We know that VA and FHA loans allow you the means of purchasing more home for the mortgage, but it only works if you are the only game in town." His advice was based on the often true notion that FHA-insured financing is slower and more laborious than conventional financing, which means FHA's valuable programs are not reaching the people they should.

FHA BACKGROUND

FHA was created as an independent entity by the National Housing Act on June 27, 1934, to encourage improvement in housing standards and conditions, to provide an adequate home financing system by insurance of housing mortgages and credit and to exert a stabilizing influence on the mortgage market. FHA was incorporated into the newly formed U.S. Department of Housing and Urban Development (HUD) in 1965. Over the years, FHA has facilitated the availability of capital for the Nation's multifamily and single-family housing market by providing government-insured financing on a loan-by-loan basis.

FHA offers multifamily and single-family insurance programs that work through private lenders to extend financing for homes. FHA has historically been an innovator. Over the past several decades, the mission of FHA's single-family programs

ship of over 3,000 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.

[2] Source: Inside Mortgage Finance, March 2, 2007.

have increasingly focused on expanding homeownership for those families who would otherwise either be unable to obtain financing or obtain financing with affordable terms. FHA's multifamily programs have allowed projects to be developed in areas that otherwise would be difficult to finance and provides needed rental housing to families that might otherwise be priced out of a community.

Additionally, the FHA program has been a stabilizing influence on the Nation's housing markets due to the fact that it is consistently available under the same terms at all times and in all places. FHA does not withdraw from markets.

THE NEED FOR FHA TODAY AND TOMORROW

The FHA single-family programs are vital to many homebuyers who desire to own a home but cannot find affordable financing to realize this dream. While the FHA has had a number of roles throughout its history, its most important role today is to give first-time homebuyers the ability to climb onto the first rung of the homeownership ladder and to act as a vehicle for closing the homeownership gap for minorities and low- and moderate-income families.

Despite this country's recent record high levels of homeownership, not all families share in this dream equally. As of the first quarter of 2006, the national homeownership rate stood at 68.5 percent, but only 51 percent of minorities owned their own home. Only 48 percent of African-Americans and 49.4 percent of Latinos owned their own homes. This compares with 75.5 percent of non-Hispanic white households.

By the end of 2005, 84.3 percent of families earning more than the median income owned their own home, while only 53.1 percent of families below the median income owned their own home.

These discrepancies are tragic because homeownership remains the most effective wealth-building tool available to the average American family.

FHA'S RECORD

More than any other nationally available program, during the 1990s, FHA's impact focused on the needs of first-time, minority, and/or low- and moderate-income borrowers.

In 1990, 64 percent of FHA borrowers using FHA to purchase a home were first-time homebuyers. Today, that rate has climbed to about 80 percent. In 1992, about 1-in-5 FHA-insured purchase loans went to minority homebuyers. That number in recent years has grown to more than one-in-three. Minorities make up a greater percentage of FHA borrowers than they do conventional market borrowers.

FHA is particularly important to those minority populations experiencing the largest homeownership gaps. Home Mortgage Disclosure Act (HMDA) data reveal that in 2004, 14.2 percent of FHA borrowers were African-Americans, compared with 5.4 percent of conventional borrowers. Hispanic borrowers made up 15.3 percent of FHA loans, while they only were 8.9 percent of the conventional market. Combined, African-American and Hispanic borrowers constituted 29.5 percent of FHA loans, doubling the conventional market's rate of 14.3 percent. In fact, in 2004, FHA insured nearly as many purchase loans to African-American and Hispanic families as were purchased by Fannie Mae and Freddie Mac combined.

The same data demonstrates FHA's tremendous service to those American families earning near or below the national median income. Over 57 percent of FHA borrowers earned less than $50,000, which is more than double the rate of the conventional market, where fewer than 28 percent of borrowers earned less than $50,000.

Ironically, as the above numbers reveal, FHA's mission to serve underserved populations has become increasingly focused during the same period as the decline in FHA's presence in the market. FHA's impact is being lost at the very time when it is needed most. The result is that American families are either turning to more expensive financing or giving up.

It is crucial that FHA keep pace with changes in the U.S. mortgage markets. While FHA programs can be the best and most cost-effective way of expanding lending to underserved communities, we have yet to unleash the full potential of these programs to help this country achieve important societal goals.

To be effective in the 21st century, FHA should be empowered to allow it to develop products and programs to meet the needs of today's homebuyers and anticipate the needs of tomorrow's mortgage markets, while at the same time being fully accountable for the results it achieves and the impact of its programs.

Under the strong leadership of its current Commissioner, Brian Montgomery, FHA has undertaken significant changes to its regulations and operations in a very short time. In just a little more than 1 year, FHA has streamlined the insurance endorsement process, improved appraisal requirements and removed some unnecessary regulations. By doing so, Commissioner Montgomery has also instilled a spirit of change and a bias for action within FHA.

MBA compliments the Commissioner on his significant accomplishments to date, though we recognize that more work lies ahead. Lenders still report that FHA is difficult to work with and that oversight activities often focus on minor compliance deficiencies in a loan file rather than focusing on issues of true risk to FHA's insurance funds. FHA is designed to serve higher risk borrowers and MBA believes that those auditing FHA lenders must understand this and be able to differentiate this aspect of the program from intentional abuse.

MBA is confident in the Commissioner's ability to address these and other issues that are within his control. There is much though, that is beyond FHA's control and needs Congressional action.

Single-family FHA-insured mortgages are made by private lenders, such as mortgage companies, banks and thrifts. FHA insures single-family mortgages with more flexible underwriting requirements than might otherwise be available. Approved FHA mortgage lenders process, underwrite and close FHA-insured mortgages without prior FHA approval. As an incentive to reach into harder-to-serve populations, FHA insures 100 percent of the loan balance as long as the loan is properly underwritten.

FHA has a strong history of innovating mortgage products to serve an increasing number of homebuyers. FHA was the first nationwide mortgage program; the first to offer 20-year, 25-year, and finally 30-year amortizing mortgages; and the first to lower downpayment requirements from 20 percent to 10 percent to 5 percent to 3 percent. FHA has always performed a market stabilizing function by ensuring that mortgage lending continued after local economic collapses or regional natural disasters when many other lenders and mortgage insurers pulled out of these markets.

FHA's primary single-family program is funded through the Mutual Mortgage Insurance Fund (MMIF), which operates similar to a trust fund and has been completely self-sufficient. This allows FHA to accomplish its mission at little or no cost to the government. In fact, FHA's operations transfer funds to the U.S. Treasury each year, thereby reducing the Federal deficit. FHA has always accomplished its mission without cost to the taxpayer. At no time in FHA's history has the U.S. Treasury ever had to "bail out" the MMIF or the FHA.

THE FHA BUDGET FORECAST FOR 2008

The Federal assistance that FHA provides to low- and moderate-income households provides critical support for extending homeownership possibilities that the private market cannot fully address. MBA notes with great concern the administration's fiscal year 2008 budget proposal released last month which estimates that the FHA mortgage insurance fund will go into the red in fiscal year 2008 unless changes to the existing program are made or budget authority to provide additional credit subsidy is given to the Agency. Since no additional budget authority to cover these costs were included in the budget, the FHA would need to either raise premiums, curtail credit to some borrowers who today could get loans, or some combination.

To cover the expected increased costs associated with higher defaults and lower originations, the administration projects increases in the up-front mortgage insurance premium (MIP) from 150 basis points (1.5 percent) to 166 basis points will be needed. In addition, the annual MIP is assumed to increase from 50 basis points to 55 basis points. On a $200,000 loan, this is an extra $320 (from $3,000 to $3,321) due at the closing table and an additional $100 (from $1,000 to $1,100) the borrower must pay each year for the same loan. This may not seem like a lot of money, but for your typical FHA borrower—who is likely to be trying to get in their first home and may not have much in the way of a savings—this could be the difference between owning a home or continuing to sit on the sidelines of homeownership.

MBA agrees with the administration that the FHA's mutual mortgage insurance fund would run in the black, and little or no premium increases would be necessary, if FHA reform proposals were passed in Congress this year. MBA believes unlocking FHA's potential in the marketplace is the right solution in the face of the Agency's systemic inability to modernize itself, and now faces the prospect of raising fees to maintain its diminished presence in the marketplace. We urge Congress to consider solutions that will enable FHA to serve more potential homeowners.

UNLEASHING FHA'S POTENTIAL

In reviewing the status of FHA over the past decade, MBA has come to the conclusion that FHA faces severe challenges in managing its resources and programs in a quickly changing mortgage market. These challenges have already diminished

FHA's ability to serve its public purposes and have also made it susceptible to fraud, waste, and abuse. Unaddressed, these issues will cause FHA to become less relevant, and will leave families served by its programs with no alternative for homeownership or affordable rental housing.

In the fall of 2004, MBA formed a FHA Empowerment Task Force comprising of MBA member companies experienced in originating single-family and multifamily FHA loans. The Task Force discussed the long-term issues confronting FHA with the goal of developing legislative proposals that would empower it to manage its programs and policies more effectively.

The Task Force identified FHA's higher costs of originations, lessening prominence in the market, out-dated technology, adverse selection, and the inability to efficiently develop products as problems for FHA. Per the Task Force's recommendations, MBA proposed the following three steps to unleash FHA from overly burdensome statutory processes and restrictions, and to empower FHA to adopt important private sector efficiencies:

—FHA needs the ability to use a portion of the revenues generated by its operations to invest in the upgrade and maintenance of technology to adequately manage its portfolios and interface with lenders.
—FHA needs greater flexibility to recruit, manage and compensate employees if it is to keep pace with a changing financial landscape and ensure appropriate staffing to the task of managing $450+ billion insurance funds.
—FHA needs greater autonomy to make changes to their programs and to develop new products that will better serve those who are not being adequately served by others in the mortgage market.

Ability to Invest Revenues in Technology

Technology's impact on mortgage markets over the past 15 years cannot be overstated. Technology has allowed the mortgage industry to lower the cost of homeownership, streamline the origination process, and has allowed more borrowers to qualify for financing. The creation of automated underwriting systems, sophisticated credit score modeling, and business-to-business electronic commerce are but a few examples of technology's impact.

FHA has been detrimentally slow to move from a paper-based process, and it cannot electronically interface with its business customers in the same manner as the private sector. During 2004 and 2005, over 1.5 million paper loan files were mailed back and forth between FHA and its approved lenders and manually reviewed during the endorsement process. Despite the fact that FHA published regulations in 1997 authorizing electronic endorsement of loans, FHA was not able to implement this regulation until this past January, 8 years later. This delay occurred despite the fact that over the same 8 years, FHA's operations generated billions of dollars in excess of program costs that was transferred to the U.S. Treasury.

MBA believes FHA cannot create and implement technological improvements because it lacks sufficient authority to use the revenues it generates to invest in technology.

MBA proposes the creation of a separate fund specifically for FHA technology, funded by revenues generated by the operation of the MMIF. MBA suggests the establishment of a revenue and a capital ratio benchmark for FHA, wherein, if both are exceeded, FHA be authorized by Congress to use a portion of the excess revenue generated to invest in its technology. Such a mechanism would allow FHA to invest in technology upgrades, without requiring additional appropriations from Congress.

Improvements to FHA's technology will allow it to improve management of its portfolio, garner efficiencies and lower operational costs, which will allow it to reach farther down the risk spectrum to borrowers currently unable to achieve homeownership. MBA believes that such an investment would yield cost savings to FHA operations far in excess of the investment amount.

Greater Control in Managing Human Resources

FHA is restricted in its ability to effectively manage its human resources at a time when the sophistication of the mortgage markets demands market participants to be experienced, knowledgeable, flexible, and innovative. To fulfill its mission, FHA needs to be able to attract the best and brightest. Other Federal agencies, such as the Federal Deposit Insurance Corporation (FDIC), that interface with and oversee the financial services sector are given greater authority to manage and incentivize their human resources. MBA believes that FHA should have similar authority if it is to remain relevant in providing homeownership opportunities to those families underserved by the private markets. FHA should have more flexibility in its personnel structure than that which is provided under the regular Federal civil service rules. With greater freedom, FHA could operate more efficiently and effectively at a lower cost. Further, improvements to FHA's ability to manage its human capital will allow FHA to attract and manage the talent necessary to develop and implement the strategies that will provide opportunities for homeownership to underserved segments of the market.

Flexibility to Create Products and Make Program Changes

FHA programs are slow to adapt to changing needs within the mortgage markets. Whether it is small technical issues or larger program needs, it often takes many years and the expenditure of great resources to implement changes. This process overly burdens FHA from efficiently making changes that will serve homebuyers and renters better and protect FHA's insurance funds. Today's mortgage markets require agencies that are empowered to implement changes quickly and to roll-out or test new programs to address underserved segments of the market.

A prime example of this problem can be found in the recent experience of FHA in offering hybrid Adjustable Rate Mortgage (ARM) products. A hybrid ARM is a mortgage product which offers borrowers a fixed interest rate for a specified period of time, after which the rate adjusts periodically at a certain margin over an agreed upon index. Lenders are typically able to offer a lower initial interest rate on a 30-year hybrid ARM than on a 30-year fixed rate mortgage. During the late 1990's, hybrid ARMs grew in popularity in the conventional market due to the fact that they offer borrowers a compromise between the lower rates associated with ARM products and the benefits of a fixed rate period.

In order for FHA to offer this product to the homebuyers it serves, legislative approval was required. After several years of advocacy efforts, such approval was granted with the passage of Public Law 107–73 in November 2001. Unfortunately, this authority was not fully implemented until the Spring of 2005.

The problem began when Public Law 107–73 included an interest rate cap structure for the 5/1 hybrid ARMs that was not viable in the marketplace. The 5/1 hybrid ARM has been the most popular hybrid ARM in the conventional market. As FHA began the rulemaking process for implementing the new program, they had no choice but to issue a proposed rule for comment with a 5/1 cap structure as dictated in legislation. By the time MBA submitted its comment letter on the proposed rule to FHA, we had already supported efforts within Congress to have legislation introduced that would amend the statute to change the cap structure. MBA's comments urged that, if passed prior to final rulemaking, the 5/1 cap fix be included in the final rule.

On December 16, 2003, Public Law 108–186 was signed into law amending the hybrid ARM statutes to make the required technical fix to the interest rate cap structure affecting the 5/1 hybrid ARM product. At this point, FHA was ready to publish a final rule. Regardless of the passage of Public Law 108–186, FHA was forced to go through additional rulemaking in order to incorporate the fix into regulation. Thus, on March 10, 2004, FHA issued a Final Rule authorizing the hybrid ARM program, with a cap structure that made FHA's 5/1 hybrid ARM unworkable in the marketplace. It was not until March 29, 2005 that FHA was able to complete rulemaking on the amendment and implement the new cap structure for the 5/1 hybrid ARM product.

The hybrid ARM story demonstrates well the statutory straitjacket under which the FHA operates. A 4-to-6-year lag in introducing program changes is simply unacceptable in today's market. Every month that a new program is delayed or a rule is held up, means that families who could otherwise be served by the program are prevented from realizing the dream of homeownership or securing affordable rental housing.

MBA believes the above three changes will allow FHA to become an organization that can effectively manage risk and self-adapt to shifting mortgage market conditions while meeting the housing needs of those families who continue to be unserved or underserved today.

LEGISLATIVE ACTIVITY IN THE 109TH CONGRESS

MBA supported much of the legislation before the last Congress, and I would like to take a moment to offer our perspective on various provisions.

MBA supported the Expanding American Homeownership Act of 2006, H.R. 5121, a bipartisan bill which marked the first time FHA was looked at by Congress in a comprehensive way in over 10 years. In general, H.R. 5121 would have significantly streamlined and modernized the National Housing Act and unleashed FHA from a 74-year-old statutory regime that constricts its effectiveness.

Among other things, H.R. 5121 would have provided for flexible down payments, flexible risk-based premiums, an increase in mortgage limits, an extension of mortgage terms, reform of FHA's condominium program, and changes to the Home Equity Conversion Mortgage (HECM) program. MBA would like to review a number of provisions that were a part of that legislation.

Downpayment Requirements

MBA supports the elimination of the complicated formula for determining the downpayment that is currently detailed in statute. The calculation is outdated and unnecessarily complex. The calculation of the downpayment alone is often cited by loan officers as a reason for not offering the FHA product.

MBA supports improving FHA's products with downpayment flexibility. Independent studies have demonstrated two important facts: first, the downpayment is one of the primary obstacles for first-time homebuyers, minorities, and low- and moderate-income homebuyers. Second, the downpayment itself, in many cases, is not as important a factor in determining risk as are other factors. Many borrowers will be in a better financial position if they keep the funds they would have expended for a large downpayment as a cash reserve for unexpected homeownership costs or life events.

We believe that FHA should be empowered to establish policies that would allow borrowers to qualify for FHA insurance with flexible downpayment requirements and decide the amount of the cash investment they would like to make in purchasing a home.

Adjusting Mortgage Insurance Premiums for Loan Level Risk

MBA believes that FHA would be able to serve more borrowers, and do so with lower risk to the MMIF, if they are able to adjust premiums based on the risk of each mortgage they insure. A flexible premium structure could also give borrowers greater choice in how they utilize the FHA program.

It is a fact that some borrowers and loans will pose a greater risk to FHA than others. At some level, FHA should have the authority to adjust premiums based upon some borrower or loan factors that add risk. Such adjustment for risk need not be a complicated formula. MBA believes FHA could significantly mitigate the risk to the MMIF by selecting a small number of risk factors that would cause an adjustment from a base mortgage insurance premium (MIP).

A current example of this would be the fact that borrowers receiving a gift of the downpayment on a FHA-insured mortgage is charged the same premium as a borrower who puts down 3 percent of their own funds, despite the fact that the former represents a higher risk loan. FHA could better address such a risk in the MMIF by charging a higher MIP to offset some of the additional risk that such a borrower poses. In this manner, while a borrower receiving a gift of funds for the downpayment will still receive the benefits of FHA financing, they themselves would share some of the risk, rather than having the risk born solely by those making a 3 percent downpayment.

Creating a risk-based premium structure will only be beneficial to consumers, though, if FHA considers lowering current premiums to less risky loans. We would not support simply raising current premiums for higher risk borrowers.

Raising Maximum Mortgage Limits for High Cost Areas

MBA supports the proposal to raise FHA's maximum mortgage limits to 100 percent of an area's median home price (currently pegged at 95 percent) and to raise the ceiling to 100 percent of the GSEs' conforming loan limits (currently limited to 87 percent) and the floor to 65 percent (currently 48 percent). There is a strong need for FHA financing to be relevant in areas with high home prices. MBA believes raising the limits to the GSEs' conforming limits in these areas strikes a good balance between allowing FHA to serve a greater number of borrowers without taking on additional risk.

Additionally, in many low cost areas, FHA's loan limits are not sufficient to cover the costs of new construction. New construction targeted to first-time homebuyers has historically been a part of the market in which FHA has had a large presence. MBA believes raising the floor will improve the ability of first-time homebuyers to purchase modest newly constructed homes in low-cost areas since they will be able to use FHA-insured financing.

Lengthening Mortgage Term

MBA supports authorizing FHA to develop products with mortgage terms up to 40 years. Currently, FHA is generally limited to products with terms of no more than 30 years. Stretching out the term will lower the monthly mortgage payment and allow more borrowers to qualify for a loan while remaining in a product that continues to amortize. We believe FHA should have the ability to test products with these features, and then, based on performance and homebuyer needs, to improve or remove such a product.

Improvements to FHA Condominium Financing

MBA supports changes to FHA's condominium program that will streamline the process for obtaining project approval and allow for greater use of this program. It is unfortunate to note that FHA insurance on condominium units has dropped at a higher rate than the overall decline in FHA's originations. This decline contradicts the fact that in costly markets, condominium units are typically the primary type of housing for first-time homebuyers. FHA should have a much bigger presence in the condominium market.

Improvements to the Reverse Mortgage Program

MBA unequivocally supports all proposals to change the FHA's Home Equity Conversion Mortgage (HECM) program: the permanent removal of the current 250,000 loan cap, the authorization of HECMs for home purchase and on properties less than 1 year old, and the creation of a single, national loan limit for the HECM program.

The HECM program has proven itself to be an important financing product for this country's senior homeowners, allowing them to access the equity in their homes without having to worry about making mortgage payments until they move out. The program has allowed tens of thousands of senior homeowners to pay for items that have given them greater freedom, such as improvements to their homes that have allowed them to age in place, or to meet monthly living expenses without having to move out of the family home.

MBA believes it is time to remove the program's cap because the cap threatens to limit the HECM program at a time when more and more seniors are turning to reverse mortgages as a means to provide necessary funds for their daily lives. MBA further believes that the HECM program has earned the right to be on par with other FHA programs that are subject only to FHA's overall insurance fund caps. Additionally, removing the program cap will serve to lower costs as more lenders will be encouraged to enter the reverse mortgage market.

Additionally, authorizing the HECM program for home purchase will improve housing options for seniors. In a HECM for purchase transaction, a senior homeowner might sell a property they own to move to be near family. The proceeds of the sale could be combined with a reverse mortgage, originated at closing and paid in a lump sum, to allow a senior to purchase the home without the future responsibility of monthly mortgage payments. Alternatively, a senior homeowner may wish to take out a reverse mortgage on a property that is less than 1 year old, defined as "new construction" by FHA.

Finally, the HECM program should have a single, national loan limit equal to the conforming loan limit. Currently, the HECM program is subject to the same county-by-county loan limits as FHA's forward programs. HECM borrowers are disadvantaged under this system because they are not able to access the full value of the equity they have built up over the years by making their mortgage payments. A senior homeowner living in a high-cost area will be able to access more equity than a senior living in a lower cost area, despite the fact that their homes may be worth the same and they have the same amount of equity built up. Reverse mortgages are different than forward mortgages and the reasons for loan limits are different, too. FHA needs the flexibility to implement different policies, especially concerning loan limits.

MBA also supported a bill Senator Hillary Clinton (D-NY) introduced in the 109th Congress, the "21st Century Housing Act." The bill contained the following positive provisions:

Investment in FHA Infrastructure—Human Resources

MBA supported authorizing the Secretary of HUD to appoint and fix the compensation of FHA employees and officers. The bill would have called on the Secretary to consult with, and maintain comparability with, the compensation of officers and employees of the Federal Deposit Insurance Corporation. This provision can be carried out by excess revenue derived from the operation of FHA's insurance funds, beyond that which was estimated in the Federal budget for any given year. While MBA had some questions as to the funding mechanism detailed in the bill for this provision, we firmly believe that giving FHA greater flexibility in investing in its human capital is critical if it is to attract and retain the talent it needs to become a stronger and more effective program serving the needs of our Nation's homeowners and renters.

Investment in FHA Infrastructure—Information Technology

MBA strongly supported this provision which would have funded investment in FHA's information technology. This provision contemplated that excess funding derived from the operation of FHA's insurance funds, beyond that which was estimated in the Federal budget for any given year, would be used to carry out this provision. While MBA had some questions as to the funding mechanism detailed in the bill for this provision, MBA believes that upgrading FHA's technology is critical to improving FHA's management of its portfolio and lowering its operational costs. MBA also believes that such an investment will allow FHA to reach farther down the risk spectrum to borrowers currently unable to achieve homeownership.

OTHER FHA ISSUE—TREATMENT OF FHA NON-CONVEYABLE PROPERTIES

The Federal Housing Administration (FHA) provides credit insurance against the risk of foreclosure losses associated with loans originated according to FHA standards. FHA generally pays an insurance claim when it takes title (conveyance) to a property as a result of foreclosure. To convey a property and receive insurance benefits, however, FHA requires that the property be in "conveyance condition" (i.e., repaired and saleable condition). Properties that have sustained damage attributable to fire, flood, earthquake, tornado, hurricane, boiler explosion (for condominiums), or the lender's failure to preserve and protect the property are not eligible for insurance benefits unless they are repaired prior to conveyance of the property to the FHA. While HUD has in the past accepted properties in "as is" (damaged) condition on a case-by-case basis, this is rarely done. Moreover, HUD will deduct from the "as is" claim the estimated cost of repair. HUD should accept conveyance of damaged properties and not adjust the claim for the cost of repair when there was no failure on the part of the servicer to obtain hazard or flood insurance pursuant to Federal law. In addition, to the extent that a property is not conveyable or has other problems (i.e., condemned, demolished by local, State, or Federal Government or there is concern about environmental issues that preclude a private servicer from taking title to the property), HUD should be permitted to pay the full claim without the servicer taking conveyance of the property or HUD taking conveyance of the property. At this time, MBA does not believe HUD has the statutory authority to manage claims in this manner.

FHA MULTIFAMILY PROGRAMS

While this hearing is to focus attention on FHA's single-family programs, it is important to underscore the critical role of FHA's multifamily programs in providing decent, affordable rental housing to many Americans. Approximately 30 percent of families and elderly citizens either prefer to rent or cannot afford to own their own homes. FHA's insurance of multifamily mortgages provides a cost-effective means of generating new construction or rehabilitation of rental housing across the Nation. As well, FHA is one of the primary generators of capital for healthcare facilities, particularly nursing homes.

While the FHA has implemented a number of significant improvements to its single-family program over the last year, the same focus needs to be applied to improving the multifamily programs. MBA hopes that process improvements on the multifamily side of FHA will soon be discussed and implemented.

Additionally, I must voice MBA's strong opposition to the proposal in the administration's 2008 budget proposal to increase the insurance premiums on multifamily projects far above that necessary to operate a financially sound program. The net effect of this proposal will be to cause many affordable rental properties not to be built or rehabilitated and to raise rents on those families and elderly households on the projects that still go through.

There is no rationale for this fee increase except to generate additional revenue for the Federal Government as these programs are already priced to cover their costs in accordance with the Federal Credit Reform Act of 1990. We urge the committee to prohibit FHA from implementing this fee increase.

CONCLUSION

FHA's presence in the single-family marketplace is smaller than it has been in the past and its impact is diminishing. Many MBA members, who have been traditionally strong FHA lenders, have seen their production of FHA loans drop significantly. This belies the fact that FHA's purposes are still relevant and its potential to help borrowers is still necessary.

I would like to conclude my testimony by highlighting two issues which make passing FHA legislation particularly urgent this year. First, hurricane season will again be soon upon us. The disasters of Hurricanes Katrina and Rita point to the need for a financially solvent FHA that is not restricted by onerous processes and procedures. The FHA program must be ready to assist homeowners and renters who lost everything amid the destruction of the hurricanes. It must have the necessary wherewithal to step in and help work out the existing mortgages in disaster areas. FHA must have the programs necessary to meaningfully assist in the rebuilding effort. Giving FHA the mechanisms to fund adequate technology improvements, flexibilities in managing human resources, and greater authority to introduce products will ensure FHA can step in to help communities when disasters occur.

Secondly, without congressional action this year, many families face a serious risk of being unable to access FHA financing due to a recent ruling passed down by the Internal Revenue Service (IRS). On May 4, 2006, the IRS released Revenue Ruling 2006–27, which may lead the IRS to rescind the nonprofit status of a large number of nonprofits who receive funding from property sellers in providing downpayment assistance to FHA borrowers. FHA regulations require that nonprofits providing a downpayment gift have an IRS nonprofit exempt status. Due to the ruling, the IRS has indicated that it is investigating 185 organizations which provide downpayment assistance.

MBA expects this ruling to have a dramatic effect on FHA's purchase production. Before the ruling, more than one-third of FHA purchase loans had some type of downpayment assistance. Such programs currently serve tens of thousands of FHA's primary clientele: first-time homebuyers, low- and moderate-income families and minorities.

Clearly, congressional action on FHA reform this year is vital.

On behalf of MBA, I would like to thank the subcommittee for the opportunity to present our views on the important programs offered by FHA. MBA looks forward to working with Congress and HUD to improve FHA's long-standing mission and ability to serve aspiring homeowners and those seeking affordable rental housing.

Senator MURRAY. Thank you very much. And thank you to all of you for your testimony. It will all be placed in the record of this committee and all members will receive a copy.

Mr. Montgomery, let me start with you. The rising defaults and foreclosures in the subprime market did not just start this past Tuesday. The foreclosure data that was released by Mr. Robbins' association on Tuesday just indicated to us that the situation is worsening. For a great many years, the subprime market was taking market share away from the FHA. Do you think the recent upset in the markets is likely to reverse that trend?

Mr. MONTGOMERY. Thank you very much for your question. We did an historical analysis, looking at the HUMDA data and why FHA was losing market share and you can look at how our market went down and look how the subprime market went up. It became very obvious to us that we were losing a lot of our traditional borrowers, if you will, to a subprime product.

Yes, we are very concerned about the delinquency, the serious delinquency rates that were released yesterday relative to the subprime. Speaking for FHA, yes, we are concerned about that but I do want to note that during that timeframe—this is the most recent data just released yesterday—that our foreclosure rate actually went down, which it hadn't done in several months and the foreclosure rate for the subprime market is about twice that of FHA. While our 30-day delinquency number did go up, our 90-day delinquency number did go down as well. And that's about 30 percent below that of the subprime market.

So yes, we are concerned about the rise of the subprime market, what's been happening there but in many cases, a lot of those borrowers would have faired much better had they had an FHA loan and this is one of the things that we've been talking about at great length at FHA for the 18 months that I've been there, saying we need a reinvigorated FHA to be there for families who have a couple of blemishes on their credit and perhaps don't have a lot of money for a down payment.

Senator MURRAY. Well, HUD has made a claim for over 1 year that if the reform package is enacted by Congress, that the FHA market share will double in 2012. That will bring your market share from 3 percent to 6 percent. Given the recent market uncertainties, do you believe that your market share might grow beyond your 6 percent target?

Mr. MONTGOMERY. Well, let me answer that this way. We're—we're not a private corporation so the degree of our success is not necessarily market share. I do want to get that point out. However, it is important that a reinvigorated, modern FHA be there for lenders and brokers—we're not a bank, as you know, so that they can best decide which is the product that fits a particular family's situation.

For a long time, FHA did not necessarily, as we know, fill that void for the reasons that we've all gone into today. So yes, we think a new reinvigorated FHA would make us a better product and we think that as a result of that, more lenders, more realtors, will be inclined to recommend us to their clients.

If I could add one other point to that, I can't stress enough, when I first got there and talking to all the trade association members and even some other groups, that we were—and still are—a tough place to deal with. We were the slowest game in town. Our IT systems remain antiquated, although we've made some improvements and these are some of the same things I mentioned last year and some of our processes were outdated. We were one of the last organizations to electronically submit loan documents. By the way, this is something our sister agency, VA, had been doing since 1999. Some of our appraisal requirements just didn't make sense so we needed, before we even looked at improving the products that we had to improve our processes as well, to make us a product that our partners out in the field would want to use.

Senator MURRAY. Mr. Montgomery, you gave a speech last month before the National Association of Homebuilders and indicated that you thought the FHA could provide cheaper loan rates to the very same borrowers that are currently loaded into subprime mortgages. Is this the state of affairs today or will this only be the case if FHA reform legislation is enacted?

Mr. MONTGOMERY. It's a key distinction to make. Just because we serve many of the same types of borrowers as the subprime market, we are not a subprime product. We don't have any teaser rates. We don't have any prepayment penalties. We are basically a 30-year, fixed rate product. There are no surprises at the end of an ARM period. Even the ARM that we have is indexed at a much lower rate so that families avoid balloon payments. So there is really no comparison between the two types of products.

But let me also say that there is nothing, from our standpoint, to prevent some current subprime borrowers from refinancing perhaps into an FHA loan. Our eligibility criteria, though, they have to meet. That will not change with these improvements and yes, we do think that some subprime borrowers could and will fare better with an FHA product.

Senator MURRAY. So if the FHA has the ability to provide these borrowers with better rates today, why are these borrowers going elsewhere?

Mr. MONTGOMERY. Well, that's a tough one, Senator. I would say in many cases, what I've read, what I've been told, some subprime borrowers, not all, totally blurred the line between a conventional loan and a subprime loan. There have been court settlements involved with lenders that we're all aware of, where there were cases—in one case, some 750,000 cases of perhaps predatory lending involved.

So I—many times when I talk about why some families went subprime, I use the term, steered toward, because I think that's exactly what happened and way too many families were taken advantage of. All the while, you have a slow to adapt, less than nimble FHA sitting there, going what about us? We had no money to make people aware of our product, no money for consumer awareness. So it was kind of a perfect storm of a treading in the water FHA and large subprime lenders with a lot of marketing dollars coming in there and in many cases—not all—there is a place for the subprime product—but in many cases, totally blurring that line. And now, I think, unfortunately for many families, we are seeing what is going to happen as a result of some of those decisions.

Senator MURRAY. Do you have any idea what percentage of current subprime borrowers you believe would be found creditworthy under FHA's criteria?

Mr. MONTGOMERY. It's a hard number to quantify, Senator but some of our internal discussions, we think it would be in probably the hundreds of thousands.

Senator MURRAY. Ms. Poole and Mr. Robbins, do you think the rising foreclosures in the subprime market will necessarily have an impact on the business that is handled by FHA? Mr. Robbins.

Mr. ROBBINS. Let me take you through a couple of statistics, which would outline the foreclosure issue and in the subprime market. The U.S. population of mortgages is about $50 million in total. The subprime represents about 13.5 percent of that number or $6,750,000. Currently, the MBA announced that loans in foreclosure were about 4.53 percent in the subprime, which is actually half of its peak, which was in the year 2000, when it hit 9.35 percent at that time.

Of that group of loans, through loss mitigation techniques, about half don't complete the foreclosure process. So that would leave about 335,000 loans that would ultimately face foreclosure that had been in the subprime area. We note with great interest that FHA's foreclosure ratio is less than half of the subprime because—again, because of outstanding loss mitigation techniques that are employed by the Federal Housing Administration versus those of subprime companies.

It's the MBA's feeling that without question, that vast numbers of subprime borrowers would benefit significantly from FHA financing. In the past, it takes approximately 70 percent longer to process and underwrite a FHA loan versus a subprime loan. The market moved toward the efficient alternative, inappropriately in some cases, using very lax underwriting. We feel, with FHA modernization, that they could be a formidable competitor in the low to moderate income lending world. They could restore their market share relatively quickly because of the fact that with the full faith in credit of the United States Government in the guarantee portion of that, that the lowest interest rate would induce a significant number of borrowers and a short time processing frame, bridge the efficiency gap that was created. So we feel that these changes have an enormous and a very positive effect on future homeowners.

Senator MURRAY. Ms. Poole, do you care to comment?

Ms. POOLE. Yes. One of the things I'd like to make sure we note is that many more homebuyers could have been and could, in the future, use the FHA product. But one of the things that should be noted is the loan limits that are attached to the FHA product, which puts a lot of borrowers out of the market and sends them into the subprime and exotic mortgages.

I, as a practitioner, am actually facing a lot of borrowers who are now homeowners, who are facing possible foreclosures, simply from purchasing over the last couple of years and they are in upside down mortgages that they did not know they were in. As a practitioner, when talking with a lender, I was sometimes not actually given all the information the borrower was given because the borrower and lender work together.

So when you get to a point of saying, I don't know how this happened, the fact is, it happened. And so I'm looking at it saying, you know, if there had been a FHA product that would have been available for the price range that they were purchasing in, it would have given me an opportunity to help them that way. But without it being there and no matter who you are, what you want to do in the market that I work, is to own a home. So all the promises and pie in the sky seem okay because I can afford the monthly payment but not looking at the long-term effect.

Senator MURRAY. Thank you very much. Senator Bond.

Senator BOND. Thank you, Madam Chair. Commissioner Montgomery, you have certain authorities to ensure the FHA MMI fund is solvent and doesn't require a bailout from Congress and in fact, the administration's 2008 budget request assumes that.

No. 1, can you give us your personal and the administration's commitment that you will not allow MMI fund's credit subsidy to go positive in 2008 and second, GAO's testimony states that high claim and loss rates for loans with down payment assistance financing were major reasons why the estimated credit subsidy rate for MMI is projected to be positive. If that statement is accurate, why do you continue to insure these high-risk loans that may jeopardize the health of FHA?

Then I'll ask Mr. Donohue and Mr. Shear to comment on that, please.

Mr. MONTGOMERY. Do you want me to go first, Senator?

Senator BOND. Yes. I want you to lay it out and then we'll slice it.

Mr. MONTGOMERY. I just wanted to confirm that, sir. Sir, yes, while I am FHA Commissioner, the MMI fund will not go to a positive credit subsidy. We have a fallback position. We're working very hard to get FHA modernization and if you look at how we think volume would increase and thus, receipts and that would keep the credit subsidy negative, which as we all know in government, is a good thing.

However, let me just reiterate, while I am Commissioner, our fallback position would be to raise the upfront premiums modestly from 1.5 to 1.66, .016 of a percentage and a small increase in the annuals to keep that from happening.

Second, sir, on the gift down payment programs, we have worked with the Internal Revenue Service, starting gosh, probably about 1 year, year and a half ago, when they approached us about some of their concerns. I don't want to speak for the IRS but just summarizing some of their concerns, whether some—not all—of the seller funded gift down payment programs met through detached and disinterested clause for bona fide 501(c)3s. And there are some 185 or so, sir, that we're aware of. They had a revenue ruling as we're all aware of, in May of last year, saying—putting on notice, seller funded down payment programs that if you don't meet these criteria then you could be in jeopardy of losing that status.

Now, I don't want to speak ill of the IRS for a number of reasons but as we all know——

Senator BOND. During that time when we're all subject to them——

Mr. MONTGOMERY. Yes, sir. But I know they have their hands full and they are moving a little slower than we anticipated in this area. So HUD also is and has moved toward rulemaking in this area and the rule currently is over at the Office of Management and Budget for their review.

But yes sir, the FHA guidelines state that as long as someone is a 501(c)3, because you have to be a nonprofit to participate in the down payment programs, then we have to continue accepting them. We are not in the business of making the determination as to who is a 501(c)3; that is the IRS's purview.

Senator BOND. Well, I agree with the fact that the 501(c)3 determination is properly the jurisdiction of the IRS. What I'm concerned about is the impact of these gift down payments on the exposure of FHA. That's why we expect to see something and I'd like to hear Mr. Donohue and Mr. Shear talk about that.

Mr. DONOHUE. I'm sorry, mention about the reduction of FHA lower—at least, in part, the foreclosure is partly due to loss mitigation and also, I believe, the foreclosure—moratorium in the gulf—but I want to get back, sir, to your question. I mean it, I get nervous when I hear things about efficiency and modernization, even though I support it. I really do. In my opinion, a lot of money was made here the last couple of years and what I do is I see where enforcement and oversight is not applied in cases.

Senator, you mentioned about this pencil-whipping. Where I come from, they talk about a three-card Monty. This seller down payment assistance, I saw first hand several years ago and as far as I'm concerned is a three-card Monty, the way it was designed. Going back and giving money from the builder back to the lender to come up with the down payment and then what happened? It had direct results—it caused spec house—the increase in value unofficially. The next thing you know, those owners would come back and get hit with a tax bill when the land was re-evaluated and insurance and so many of them move out of the house.

I took that to the FHA and I brought this attention to them and there was great reluctance on their part. In fact, my guess is, I probably upset a lot of the Mortgage Bankers Associations. When I first came on 5 years ago, I used to get invited to a lot of their functions. That seems to have dropped off significantly the last couple of years.

But I think this—when the Commissioner speaks about modernization, I'm drawn upon to a particular matter we dealt with and this had to do with loan binders. Loan binders are the files that are kept with regard to loans executed by FHA. There was a modernization designed for those binders to be retained by the lending organizations. I have concern about that. I went to the FBI and asked them their opinion and they supported me with regard to the very concern is simple. I was in investigations for 31 years. I get real nervous when I'm going back and talking to a particular lender that might have done wrong and the very information I have, the investigation file that I have to recover to look at is maintained by them. I'd hate to think what they might do with if they really are fraudulently aggressive.

But the fact is, this was a situation that I had to challenge and the FHA Commissioner went ahead anyway and administered that modernization plan. I think it's all about aggressive enforcement over sites served.

Senator BOND. Then Mr. Shear and then I'm going to have, since we've mentioned Mortgage Banking Associations, I'm sure that Mr. Robbins may have a view on that. So let me hear from Mr. Shear.

Mr. SHEAR. Thank you, Senator Bond. First, you said something about the subsidy rates and whether a positive subsidy would be required. Over the last few years, part of the improvements that we have noted with FHA is their ability to improve their models for estimation purposes. At the same time, we're trained to be skeptical, and when you see underestimated costs year after year, we still have a reason for some pause. But by the same token, these models have improved. I would expect as the Commissioner has said, with an increase in premiums under current statutory authority, that the program can be made a negative subsidy program in fiscal year 2008.

On the second issue of down-payment assistance, even though we have monitored developments at the IRS, we haven't conducted audits of IRS. Our audit has been of FHA and we have recommended that the seller-funded down payment assistance that has become such a major share of FHA's portfolio, be treated as a seller inducement. At the time we made that recommendation, the response from FHA was that FHA was bound by a HUD Office of General Counsel legal opinion that said that this couldn't be treated as a seller inducement. We don't have a legal opinion about the legal opinion but as a matter of policy, we continue to believe FHA has to take action to deal with seller-funded down payment assistance.

Senator BOND. Mr. Robbins.

Mr. ROBBINS. The down payment assistance program makes up about a third of FHA's current business and its our position that allowing a flexible down payment will effectively do away with abuses in the program and so the answer to that is a more flexible down payment program.

Senator BOND. Tell me how that—what do you mean by a flexible down payment program? I don't really understand what that flexible——

Mr. ROBBINS. Doing away with the formula driven down payment program that is today providing a real zero down program that we can introduce to borrowers. We're not in the business of developing down payment assistance programs, the Mortgage Bankers Association is not. And we are in the business of opining that we want a safe and sound and healthy Federal Housing Administration and support proposals that keep it actuarially sound. But we also are aware that the FHA down payment assistance or the down payment assistance program is being used, principally by low-income and minority buyers in order to get into their house and what we have found is you have seen in traditional marketplace—43 percent of first time homebuyers last year used a zero down payment program. If we were able to adopt a similar kind of program through FHA on a direct program, it would do a lot to go to—to curb the abuses in the DAP program that you see today.

Senator BOND. The public policy goal of getting people into first time houses is extremely important but I am very much concerned about the historical evidence that we've seen that when you don't have skin in the game, when you haven't put something up, when there is no equity value in the home, this puts the homeowner too often in a squeeze where something comes along, a furnace breaks down, a roof leaks, there is no headroom in it. So is this not a problem?

Mr. ROBBINS. You know, to me, it depends on how the borrower is underwritten and there is nothing that takes the place of good old common sense. I mean, there are situations where 100 percent loan to value program is fine for a borrower, properly underwritten. There are some cases where the borrower, with a no-down product is not ready for home ownership yet. And my belief is that a well applied underwriting program adopted by the FHA under that program with the appropriate risk pricing behind that, would go a long way to benefit the homeowners who need that kind of financing and in fact, quality for it versus them using a subprime alternative.

Senator BOND. Ms. Poole, did you want to comment on that?

Ms. POOLE. I sure would. There are a couple of things that I think come into play. One of things is that with the seller funded down payment assistance, it really increases home prices, which start to price people, especially first time homebuyers, out of the market. So we have to keep that in mind.

Flexible down payment would not have the same impact. But flexible down payments are based on credit scores, it's based on credit histories and how a person handles themselves credit-wise.

So the zero down is not something that is even being talked about for everyone. It's on a sliding scale, depending upon where you are and what you're doing. Again, as a practitioner, I work with mostly first time homebuyers and I would say that every time they make a monthly payment, to them, they have invested into that home. Rather they didn't put it all in upfront or with the 3 percent or whether they are doing 80/20, it's when they make that first payment that they feel as though I have vested interest in how this works.

One of the most important things that I think has to be talked about and has to be considered is the education portion that comes into play when people, first time homebuyers buy homes. Without the education piece, sometimes people can get in to situations that they are not prepared for and as for the National Association of Realtors, we are 100 percent in agreement that people need to be educated in the home-buying process long before they decide to make that first home purchase.

Senator BOND. Thank you very much. Madam Chair, I will have other questions for the record but I have another commitment.

Senator MURRAY. Okay, very good.

Senator BOND. I thank the witnesses and you've given some enlightenment and a little bit of confusion on a very important subject and we appreciate your efforts to help us straighten it out.

Senator MURRAY. Thank you very much, Senator Bond. We will make sure your questions get submitted to the record and ask that everyone give their responses back to us.

I do have a few more questions I want to ask and I'll start with you, Mr. Montgomery. Two weeks ago, Secretary Jackson testified before the House Appropriations Committee and said that HUD had changed its position about allowing FHA to offer mortgages with a zero down payment and he went on to say he was not opposed to requiring a 1 or 2 percent down payment requirement. But since that hearing, now HUD has indicated you do not intend to change your reform proposal and zero down payment mortgages will still be permitted. What exactly is the administration's position on this?

Mr. MONTGOMERY. Right now we have a standard minimum 3 percent cash requirement and that can take many different shapes and forms. We are asking and we haven't transmitted a bill but again, it will look very similar to last year's bill, the ability to do away with the requirement of the 3 percent. Now that may mean that either through closing costs assistance or the person finances the upfront mortgage insurance premium and puts some money down that there is some cash in the game. It may be at 99.95 LTV loan but there will be some minimum cash investment on the part of the borrower. It may be that the down payment is a very small number but their cash contribution comes from elsewhere.

Senator MURRAY. But will you be asking for authority for zero down payment mortgages?

Mr. MONTGOMERY. We will be asking authority for flexibility in the cash requirement to include the down payment assistance, to include other cash participation the borrower may do. I also want to say that we do need some flexibility in that area because it's just too difficult. There are a lot of borrowers who would qualify but just don't have the cash and they are creditworthy low-income borrowers and for many of them, they turn to the subprime product, many of them turn to the gift down payment programs. So yes, we do need some flexibility in that requirement.

Senator MURRAY. Well, Ms. Poole, in her formal testimony, said that 43 percent of all mortgages to first time homebuyers in 2005 involved no down payment. And now we're seeing this alarming increase in delinquencies and foreclosures in the subprime market that involve these no down payments. So the administration's FHA reform proposal that would essentially allow no down payments, zero down payments, how are you going to ensure, under this proposal if you move toward that, it won't suffer the same fate as the subprime?

Mr. MONTGOMERY. I can't speak for the subprime but I can speak for FHA and no, ma'am, it will not. Our eligibility criteria will not change. If anything, when a borrower chooses to put less cash down in the transaction, the eligibility criteria will strengthen. I have an obligation to this committee, to this body, to the taxpayers, to make sure the FHA fund is operated in a financially sound manner. So as a result of that, we will not change that criteria. It is not our intent to make homeowners out of families who are not ready to become homeowners. But I would submit that there are working families out there, whether they are social workers, librarians or mechanics, who save a little here and there for a down payment. They are good, creditworthy, hardworking families but they have a little bump in the road, the transmission goes out on the car. You name it and there goes the cash savings. I would submit that there are tens if not hundreds of thousands of families like that, who don't want a handout. They just need a hand, because they pay for this premium. It's not a Government handout. So those are those hardworking, creditworthy, low-income borrowers that we are trying to reach.

Senator MURRAY. Have you done a thorough analysis that will tell us that we'll be able to guarantee these zero down payments that you could share with the committee?

Mr. MONTGOMERY. We have done actuarial reviews of all our products and since we haven't transmitted the bill yet, we have a whole pricing structure that we're still reviewing. But bare in mind, we would price the product with FHA reform, commensurate with the risk. So any borrower again, who might be a higher risk and is choosing to put lower down, will pay for that privilege, if you will. But look at what they get in return. They get a fixed rate loan over a longer period. They have no teaser rates that they have in the subprime, which for many of them, is their only option today and they have no prepayment penalties. The FHA is a fully amortizing product. So I would say it is a far, far better option for many of those families.

Senator MURRAY. Mr. Shear and Mr. Robbins, do you have any comments on that?

Mr. SHEAR. On the zero-down product, one of the things that we found from our work, which is consistent with other research, is that a zero-down product does carry higher risk, higher risk of default. And while it is a congressional prerogative whether to allow FHA to have a zero-down product, we believe it should be provided on a pilot basis. When you look at other mortgage providers, when they offer a zero- or low-down product, they always pilot the program because it is very risky to go into an activity if you don't understand the risks of that activity and pilot programs allow that understanding to occur.

So that is basically our position. It isn't one of whether to allow zero down or not, but if Congress were going to allow it, it should be a pilot program.

Senator MURRAY. Dr. Donohue?

Mr. DONOHUE. Senator, the seller down payment is twice the default rate and I look forward to hearing more from FHA with regard to how they can ensure that will not have an adverse effect on the FHA.

But I want to say one last thing and that's the fact is, my concern remains with the relationship between FHA and the lenders. I think without aggressive enforcement and I'm concerned about what I've seen, aggressive enforcement, I think—that's where I think a lot of problems might exist with regard to what I see in the future. Thank you.

Senator MURRAY. Mr. Robbins.

Mr. ROBBINS. A couple of comments. The lower down payment program would be offset by higher risk premiums that are charged. I don't think you can compare a subprime, no income, no asset loan to a fully documented FHA loan. The underwriting process is completely different and a substantial amount of the loss mitigation would be seen under an FHA program because they are really documenting every aspect of a borrower's assets and income, where obviously, under a subprime, no income, no asset loan, that responsibility would be abdicated.

Here is my basic concern, being a lender and having been one for many, many years and having experienced and done literally billions of dollars of first time homebuyer loans. We're looking at a market that will grow from $10 trillion in outstanding mortgage debt today to $20 trillion estimated within the next two decades, in less than two decades. Harvard's Joint Center for Housing Studies has said that during that period of time, because of the changing demographics of this country, that 66⅔ percent of first time homebuyers will be minority Americans buying their first house. We have to have programs that meet that demand. We have a tidal wave of opportunity that is occurring in this country, to convert people and give them their share of the American dream and let them put their stake in the ground in home ownership. We have to have the programs to meet that demand and a well-founded FHA with solid underwriting is going to allow us to do that.

Senator MURRAY. Thank you very much. I do have one other question. Senator Bond put language in our 2007 appropriations bill that would clamp down on fraudulent gift down payment assistance programs. Mr. Donohue and Mr. Shear, do you think that language—I don't know if you're familiar with it but do you think that would adequately get at the crooked actors without harming the real nonprofits that are trying to get people into homes?

Mr. DONOHUE. Senator, I support that. I think that currently, with the best intentions and the review that is underway, the seller down payment assistance program is still going on. And I'd like to see it end as quickly as possible so I support any notion of that type.

Senator MURRAY. Mr. Shear.

Mr. SHEAR. I'm not familiar with the provisions related to this but certainly, it sounds promising and for us, again, the reason we think FHA should treat it as a seller inducement is because, for all practical purposes, it is. And just to make clear, even though we found that loans with more traditional—what I'll call the old fashioned kind of down payment assistance, where it comes from a charity, from a foundation, where there is real equity created in a home because of the down payment assistance—even though the performance of those loans wasn't quite as good as other loans, our concern isn't with the more traditional down payment assistance. It's with this particular mechanism of seller-funded assistance that has become such a large share of FHA's portfolio.

Senator MURRAY. Mr. Montgomery.

Mr. MONTGOMERY. I just want to make sure that we understand there is a wide difference between a seller-funded gift down payment and a zero-down product. In many cases, the cost of the down payment, if you will, for the seller funded, the charitable one, if you will, is put on at the end of the loan and along with other costs that a borrower may have, they could be in a higher than 100 percent LTV posture, whereas a traditional down payment, you don't have that. It's not a loan you're paying back. You are putting some money in the game so there is a big difference between the two products.

But again, just to reiterate the point I made earlier, we have been working with the IRS. We have been working on a rule and I understand Mr. Donohue's frustration with that but we've moved closer to that point than probably any previous Commissioner and these are not new products. These gift down payments have been around since the late 1990's.

Senator MURRAY. And do you have a comment on Senator Bond's language in the appropriations bill?

Mr. MONTGOMERY. I think if that is what it gets to, then that's the way we would go but I would add again, that the IRS has a revenue ruling out. HUD is moving, FHA may be moving a rule and is currently at OMB.

ADDITIONAL COMMITTEE QUESTIONS

Senator MURRAY. That is all the questions I have at this point. I believe we have some questions from other members that we will submit for the record. If you would respond back, I would appreciate it.

[The following questions were not asked at the hearing, but were submitted to the Department for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO HON. BRIAN D. MONTGOMERY

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

DOWNPAYMENT ASSISTANCE LOANS

Question. Do you support the elimination of these loans? Are you committed to implementing the GAO's recommendations and stopping the practice of insuring these types of high-risk loans? When do you expect your proposed ruling to be implemented?

Answer. Last year HUD published a rule that would eliminate these high-risk loans, however implementation has been delayed due to litigation. We are currently awaiting a court ruling on how to proceed.

Question. Would you support a legislative provision in the THUD appropriations bill that prohibits FHA from engaging in this activity?

Answer. The fiscal year 2009 budget proposes new risk categories for these high risk loans. This risk category bears a positive subsidy rate of 6.35 percent. Should Congress wish FHA to continue to insure these loans, we will require an appropriation to cover the very substantial anticipated cost to the Government of such loan guarantees.

FHA'S STRUCTURE

Question. It is my belief that FHA reform be comprehensive and address some of the structural issues that have impeded FHA's ability to manage effectively the risk of its insured mortgages. I believe having some flexibility in hiring (possibly similar to the FDIC and other quasi-governmental entities) and purchasing authority can help the FHA function more like a business.

Can you comment on how the current structure impacts FHA's operations and what types of flexibility you need to ensure FHA can be more responsive and accountable? In terms of your workforce, are you currently facing a large number of retirements like the rest of the Federal Government and how will that impact FHA?

Answer. For now, we believe that flexibility to increase the FHA funding used for information technology systems would help. We are also attempting to bring new employees on board so they can be trained before experienced staff retires. We do believe these measures will allow us to meet both the challenges of implementing the new legislation and to deal with the very dynamic home mortgage market.

ASSET CONTROL AREA PROGRAM

Question. In the fiscal year 1999 VA–HUD Appropriations Act, the Congress created the Asset Control Areas (ACA) to address the growing number of FHA-foreclosed homes in distressed communities and to promote homeownership to stabilize these neighborhoods. Our intent was for HUD to work with nonprofits and local governments in implementing this program.

Can you give me an update on the program, in terms of how many new contracts have been approved in the last year? How long does it typically take HUD to approve these contracts?

Answer. In fiscal year 2007 one new agreement was approved and one was renewed. Once the ACA participant submits a completed package and accepts the terms of the model agreement, the package is approved within 30–45 days.

IMPACT OF SUBPRIME MARKET

Question. There has been a lot of attention to the subprime market and its recent problems as thousands of subprime loans are going into default and foreclosure. The Federal Reserve chairman recently suggested that the subprime problems could have broader economic consequences and some on Wall Street fear that it will spread to the prime market and to corporate credit.

How has the subprime market affected FHA's business and market-share over the past several years? In other words, did the subprime market attract borrowers who would have traditionally been served by FHA? Second, looking forward, since the subprime market is imploding, will many borrowers return to FHA? Do you see an increase in business happening? Lastly, with many of the subprime mortgages likely to end up in foreclosure, will it cause a domino effect on homes insured by FHA?

Answer. Subprime lenders attracted a significant number of borrowers who would have qualified for, and likely used, FHA. Many of these borrowers are expecting to refinance out of their subprime loans before they reset to a higher interest rate. As with the FHA Secure initiative announced last year, we are exploring ways to assist these families, so we do expect an increase in business. Our borrowers continue to be required to meet FHA's underwriting standards before any loan is insured. Consequently, with the exception of the gift downpayment loans, we do not expect an increase in claims.

MANAGING RISK

Question. The GAO has raised several concerns with FHA's ability to manage risk and that it could impact its ability to manage new products such as the proposed no down-payment mortgage product.

Given the GAO and IG's concerns, the downturn in the housing market, and the record delinquency rate of FHA loans, what safeguards or limitations would FHA place on its risk-based premium and low to zero down-payment products? How will you ensure that borrowers will not be put at risk of owing more than the value of the home? What are your thoughts on piloting a program as suggested by the GAO?

Answer. With the exception of seller financed gift downpayment loans, we do not anticipate large numbers of FHA borrowers being put in a position of owing more than their homes are worth, aside from widespread declines in market values that adversely affect all borrowers. We believe the serious problems confronting the housing market as a whole are not appropriate for a limited demonstration, but rather require a program available to all who need it and who qualify.

COSTS OF IMPLEMENTING RISK-BASED PRICING SYSTEM

Question. The IG's testimony states that moving to a risk-based premium pricing structure could require additional budget authority funding to make FHA system modifications. Further, this new pricing system could impose new administrative/cost burdens on originating and servicing lenders, according to the IG.

Does your budget request include funding to address the system modifications suggested by the IG? If so, how much would it cost in fiscal year 2008 and in the out years? Have you analyzed the potential administrative/cost impact of the proposed risk-based pricing structure on lenders?

Answer. The modifications to FHA systems have been completed. We don't anticipate increased annual requirements solely because of the implementation of risk-based pricing. At the same time, however, FHA systems are as much as 27 years old. They all need to be upgraded or replaced.

FAIR HOUSING CONCERNS WITH RISK-BASED PRICING

Question. The IG's testimony raises fair housing and red-lining concerns with the administration's risk-based pricing proposal. How are you addressing these concerns?

Answer. The Department does not believe that the risk-based pricing will have a discriminatory effect on minority households or neighborhoods. Quite to the contrary, risk-based pricing will allow FHA to more effectively carry out its mission of promoting home ownership by lower income families, especially minorities and first-time homebuyers. With greater pricing flexibility, FHA will be able to reach more families and offer more financing options at more affordable cost.

FHA FRAUD

Question. The IG's testimony listed a number of areas of continuing concern related to FHA fraud. One area of concern was FHA's adoption of a new policy dealing with the Lender Insurance Program. FHA implemented the new policy to this program despite opposition from the FBI and HUD's OGC but committed to making technical corrections to the new policy after implementation. What sort of progress have you made in making technical corrections to this program?

Answer. The Lender Insurance (LI) program is a process that allows for insurance of loans by lenders without prior review by HUD staff. LI loans are subject to the same Direct Endorsement standards with the exception of those requirements that are unique to the LI process. Risk management controls for all Direct Endorsement loans include Social Security Number validation, property flip check of all purchase mortgage loans, electronic review of all insuring data prior to endorsement, analysis of all closed loans to select high risk loans for review, analysis of all lenders to identify the high risk lenders for review, electronic monitoring of each lender's claim and default rates in Neighborhood Watch to determine compliance with FHA approval standards and termination of a lender's origination or underwriting approval for poor performance under Credit Watch Termination.

FHA is working with Regulation Division attorneys on two revisions to current HUD single-family regulations. The first revision would revise the regulations to provide a definition of the term "origination" and clarify that LI is a process and that loans insured under this process are subject to the current Direct Endorsement statutes, regulations and policies.

FHA, under existing regulatory authority to hold program participants fully accountable for their actions, has adopted procedures for dealing with any LI lender that fails to produce a case binder when requested, which is the major source of OIG's concern. The second revision would revise the regulations to require that lenders indemnify HUD for failure to submit a case binder when requested or for failure to submit a case binder with sufficient documentation to determine eligibility of Federal Housing Administration (FHA) mortgage insurance. This revision enhances existing regulatory authority and procedures for dealing with a LI lender who fails to produce a case binder when requested.

FHA would also like to point out that, despite OIG's concerns, those lenders making loans under the LI program have a better record of loan performance than do those lenders that still submit binders to FHA for insuring purposes. LI is a privilege and not a right and LI lenders are abiding by FHA's requirements.

RESPA REFORM

Question. A few years ago, the administration proposed reforms to the Real Estate Settlement Procedures Act (RESPA) to simplify the mortgage process and to provide certainty to borrowers about their costs. The proposed rule, however, was withdrawn. Does the administration have any plans to reform RESPA?

Answer. Yes, the Department looks forward to publication of the rule and public comment very soon. The Department will work with Congress on this very important rule. The goals are to simplify and improve the disclosure requirements for mortgage settlement costs under RESPA, and to protect consumers by making it possible for consumers to shop for the loan and settlement services that best meet their needs.

Questions Submitted by Senator Arlen Specter

RISK-BASED PRICING

Question. Risk-based pricing may increase the mortgage carrying costs of those FHA borrowers that are least able to afford them and there is a greater risk of default on zero downpayment loans. How do you plan to prepare for and protect against these risks and ensure that low-income families are not led to greater financial instability?

Answer. FHA will continue to use its very effective underwriting process to ensure that families qualify for and can afford the mortgages they are seeking.

FHA LOAN LIMITS

Question. Raising FHA area loan limits could distance FHA from the lower-income families it was established to serve. How will raising the loan limits help the lowest-income families who have the fewest alternative options?

Answer. We have effectively been eliminated as an option for low-income families in high cost areas such as California and New York. Raising the limits will allow FHA to once again serve low-income and first-time homebuyers in these areas.

Questions Submitted to Hon. Kenneth M. Donohue

Questions Submitted by Senator Christopher S. Bond

FHA FRAUD

Question. Your testimony listed a number of areas of continuing concern related to FHA fraud. One area of concern was FHA's adoption of a new policy dealing with the Lender Insurance Program.

What is the significance of this problem?

Answer. The Lender Insurance Program allows certain FHA-approved direct endorsement lenders to endorse FHA insured loans without a pre-endorsement review and generally relieves the submission of loan origination case binders to FHA. OIG expressed concern that relieving Lender Insurance Program lenders from the responsibility of submitting loan origination case binders to FHA may adversely impact the ability to investigate and prosecute fraud perpetrated upon FHA.

FHA'S STRUCTURE

Question. As I stated in my opening statement, I strongly believe that FHA reform should address some of the structural issues with FHA that has impeded its ability to manage effectively the risk of its insured mortgages. I believe having some flexibility in hiring (possibly similar to the FDIC and other quasi-governmental entities) and purchasing authority can help the FHA function more like a business.

Do you believe that FHA's current structure impedes their ability to perform their mission in a sound and effective manner?

Answer. The OIG has not independently assessed whether FHA's current structure impedes its ability to perform its mission in a sound and effective manner. However, based on our audit and investigative activities we are concerned with the ability of FHA's staff and its current systems (i.e., reliability) to implement and manage the various new programs/products proposed as part of FHA reform.

Since fiscal year 1991, we have reported annually on the Department's lack of an integrated financial system in compliance with all Federal financial management systems requirements, including the need to enhance FHA's management controls over its various insurance and other financial systems. Organizational changes and human capital management have not only been a challenge to FHA, but the Department as a whole for many years. As such, FHA has contracted out a number of its functions that are essential to the accomplishment of its overall mission.

The Department has made progress in implementing a new financial system at FHA, but continued progression in the integration of FHA's financial management systems, and strengthening of lender accountability and enforcement against program abuses is still needed.

HIGH-RISK STATUS OF FHA

Question. The GAO recently removed the high-risk designation for FHA's single-family programs because of the agency's progress in addressing its long-standing problems. However, the GAO warns that FHA's proposed changes to raise its loan limits, implement a new risk-based premium system, and reduce down-payment requirements, could introduce new risks and oversight challenges to FHA.

Despite the removal of GAO's high-risk designation, is FHA still vulnerable to waste, fraud, and abuse?

Answer. The Department has made progress in its efforts to correct some of its challenges and we commend the removal of FHA's single-family programs from GAO's high-risk list. However, FHA is still vulnerable to waste, fraud, and abuse, especially with the changes proposed as part of FHA reform.

We are concerned with the soundness of the front-end risk assessments performed by or on behalf of the Department for the various proposed operational and programmatic changes that are part of or related to FHA reform. Therefore, we have begun an audit of FHA's control structure, which includes a review of its front-end risk assessment process, to ensure cost/performance effective actions are taken to minimize undesired outcomes and maximize the likelihood of desired outcomes.

Additional risk is inherent with the introduction of any new program/product and it must be balanced with a commensurate increase in oversight and enforcement, which was lacking from the various FHA reform proposals. Without such protections to mitigate future insurance losses one cannot ensure the effectiveness of FHA in meeting its overall mission, which includes maintaining and expanding homeownership. The OIG is committed to continuing its work with the Department to ensure the integrity of FHA's single-family insurance programs.

QUESTIONS SUBMITTED TO WILLIAM B. SHEAR

QUESTIONS SUBMITTED BY SENATOR CHRISTOPHER S. BOND

Question. The GAO recently removed the high-risk designation for FHA's single-family programs because of the agency's progress in addressing its long-standing problems. However, the GAO warns that FHA's proposed changes to raise its loan limits, implement a new risk-based premium system, and reduce down-payment requirements, could introduce new risks and oversight challenges to FHA.

Despite the removal of GAO's high-risk designation, do you believe FHA is still vulnerable to waste, fraud, and abuse? Will FHA's proposed new loan products potentially expose FHA to more risk and if not managed adequately, is it possible for FHA to be placed back on the high-risk list?

Answer. We removed the high-risk designation in January 2007 because of the progress FHA had made in addressing weaknesses we had identified in its risk management, including improvements in lender oversight and loan performance modeling.[1] Because of this progress, we believe that FHA is less vulnerable than it has been in the past to risks that could undermine the efficiency and effectiveness of its single-family mortgage insurance programs. However, as we noted in our High-Risk Update and our June 2007 report on FHA's modernization efforts, some of FHA's proposed program changes could introduce new risks and challenges.[2] FHA's proposal to offer products with lower down-payment requirements is of particular concern given the greater default risk of low-down-payment loans, housing market conditions that could put borrowers with such loans in a negative equity position, and the difficulty of setting prices for new products whose risks may not be well understood. Due partly to these risks and challenges, we included FHA's single-family insurance programs on a list of suggested areas for oversight that we provided to Congress in November 2006.[3] To make any future decisions about the high-

[1] GAO, High-Risk Series: An Update, GAO–07–310 (Washington, DC: January 2007).

[2] GAO, Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management, GAO–07–708 (Washington, DC: June 29, 2007).

[3] GAO, Suggested Areas for Oversight for the 110th Congress, GAO–07–235R (Washington, DC: Nov. 17, 2006).

risk status of this program area, we would use published criteria that encompass a number of quantitative and qualitative factors.[4] Additionally, we would review a wide range of data and documentation, including information on FHA's ability to manage the risks of any new mortgage products it is authorized to offer.

Question. In your testimony, you state that high claim and loss rates for loans with down-payment assistance financing were major reasons why the estimated credit subsidy rate for the FHA MMI Fund is projected to be positive for fiscal year 2008. HUD has recently developed a proposed rule to address these types of loans.

Can you elaborate on why these types of loans perform so poorly and what specific recommendations you have made to address these problems? How do these loans perform compared to subprime loans? Do you believe HUD's proposed rule adequately addresses your concerns and recommendations?

Answer. Our testimony focused specifically on the high claim and loss rates for loans with down-payment assistance from nonprofit organizations that received at least part of their funding from property sellers (seller-funded nonprofits). These loans are problematic because property sellers that provide down-payment assistance through nonprofits often raise the sales prices of the homes involved in order to recover the required payments to the nonprofits. For example, in November 2005, we reported that FHA-insured homes bought with seller-funded nonprofit assistance appraised at and sold for about 2 to 3 percent more than comparable homes bought without such assistance.[5] The weaker performance of loans with seller-funded down-payment assistance may be explained, in part, by the higher sales prices and the homebuyer having less equity in the transaction. Seller-funded down-payment assistance effectively undercuts FHA requirements that help to ensure that FHA homebuyers obtain a certain amount of "instant equity" at closing. That is, when the sales price represents the fair market value of the house, and the homebuyer contributes 3 percent of the sales price at the closing, the loan-to-value ratio (i.e., the ratio of the amount of the mortgage loan to the value of the home) is less than 100 percent. But when a seller raises the sales price of a property to accommodate a contribution to a nonprofit that provides down-payment assistance to the buyer, the buyer's mortgage may represent 100 percent or more of the property's true market value. In prior work, we found that, controlling for other factors, high loan-to-value ratios lead to increased insurance claims.

Our 2005 report made recommendations designed to better manage the risks of loans with down-payment assistance generally and from seller-funded nonprofits specifically. We recommended that FHA consider risk mitigation techniques such as including down-payment assistance as a factor when underwriting loans. We also recommended that FHA take additional steps to mitigate the risk associated with loans with seller-funded down-payment assistance, such as treating such assistance as a seller inducement and therefore subject to the prohibition against using seller contributions to meet the 3 percent borrower contribution requirement. Consistent with the first recommendation, FHA is testing additional predictive variables, including source of the down payment, for inclusion in its mortgage scorecard (an automated tool that evaluates the default risk of borrowers). HUD's proposed rule to prohibit seller-funded down-payment assistance is responsive to the second recommendation.

It is difficult to compare the performance of FHA-insured loans with seller-funded down-payment assistance to subprime loans because of differences in the way performance data are reported. (For example, FHA measures the percentage of loans, by origination year, that completed the foreclosure process and resulted in an insurance claim. In contrast, the Mortgage Bankers Association's National Delinquency Survey—which provides data on prime, subprime, and government-insured loans—measures the percentage of loans being serviced, regardless of origination year, that were in any stage of the foreclosure process.) FHA has reported that, as of January 2007, 15.6 percent of fiscal year 2000 loans with down-payment assistance from nonprofits (the large majority of which received funding from property sellers) had resulted in an insurance claim. For this and more recent books of business, the claim rates for loans with this type of assistance were at least twice as high as the claim rates for all FHA-insured purchase loans.

Question. As I stated in my opening statement, I strongly believe that FHA reform should address some of the structural issues with FHA that has impeded its ability to manage effectively the risk of its insured mortgages. I believe having some

[4] GAO, Determining Performance and Accountability Challenges and High Risks, GAO–01–159SP (Washington, DC: November 2000).

[5] GAO, Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance, GAO–06–24 (Washington, DC: Nov. 9, 2005).

flexibility in hiring (possibly similar to the FDIC and other quasi-governmental entities) and purchasing authority can help the FHA function more like a business.

Do you believe that FHA's current structure impedes their ability to perform their mission in a sound and effective manner?

Answer. In our June 2007 report on FHA's modernization efforts, we discussed options that FHA and Congress could consider to help FHA adapt to changes in the mortgage market and the pros and cons of these options.[6] Some of these options could help the agency perform its mission more effectively by increasing its operational flexibility. For example, we noted that mortgage industry participants and researchers had indicated that Congress could consider granting FHA additional authorities to invest in staff and technology. Specifically, Congress could allow FHA to manage its employees outside of Federal pay scales. Some Federal agencies, such as the Securities and Exchange Commission, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation, are permitted to pay salaries above normal Federal pay scales in recognition of the special skills demanded by sophisticated financial market operations. The Millennial Housing Commission and mortgage industry officials have suggested that FHA be given similar authority.[7] This option could help FHA to recruit experienced staff to help the agency adapt to market changes and could be funded with the Mutual Mortgage Insurance Fund's current resources—that is, negative subsidies that accrue in the Fund's reserves. However, the Fund is required by law to operate on an actuarially sound basis. Because the soundness of the Fund is measured by an estimate of its economic value—an estimate that is subject to inherent uncertainty and professional judgment—the Fund's current resources should be used with caution. Spending the Fund's current resources would lower the Fund's reserves, which in turn would lower the economic value of the Fund. As a result, the Fund's ability to withstand severe economic conditions could be diminished. Also, using the Fund's current resources would increase the Federal budget deficit unless accompanied by corresponding reductions in other government spending or an increase in receipts.

Question. The GAO has raised several concerns with FHA's ability to manage risk and that it could impact its ability to manage new products such as the proposed no down-payment mortgage product. And now, the delinquency rate for FHA loans are at a new record level according to the latest Mortgage Bankers Association's Delinquency Survey. In fact, MBA's data seems to indicate that FHA loans are as risky, if not more risky, than subprime loans.

Given FHA's track record in managing its existing portfolio of loans and risky loans such as those with high loan-to-value ratios, should we be concerned about FHA's ability to manage effectively its proposed no- or low-down-payment loan programs?

Answer. In our June 2007 report on FHA's modernization efforts, we expressed concerns about the proposal to lower down-payment requirements potentially to zero given the greater default risk of loans with high loan-to-value ratios, policies that could result in effective loan-to-value ratios of over 100 percent, and housing market conditions that could leave borrowers with such loans with negative equity.[8] We noted that sound management of very low or no-down-payment products would be necessary to help ensure that FHA and borrowers do not experience financial losses. Piloting or otherwise limiting the availability of new products would allow FHA the time to learn more about the performance of these loans and could help avoid unanticipated insurance claims. Despite the potential benefits of this practice, FHA generally has not implemented pilots, unless directed to do so by Congress. We have previously indicated that, if Congress authorizes FHA to insure new products, Congress and FHA should consider a number of means, including limiting their initial availability, to mitigate the additional risks these loans may pose. We continue to believe that piloting would be a prudent approach to introducing the products authorized by FHA's legislative proposal.

[6] GAO–07–708.

[7] The Millennial Housing Commission, established by Congress in 2000, studied the Federal role in meeting the Nation's housing challenges and issued a report in 2002, which included recommendations for a variety of reforms to Federal housing programs. See Meeting Our Nation's Housing Challenges: Report of the Bipartisan Millennial Housing Commission (Washington, DC: May 30, 2002).

[8] GAO–07–708. Loans with low or no down payments carry greater risk because of the direct relationship that exists between the amount of equity borrowers have in their homes and the risk of default. The higher the loan-to-value ratio, the less cash borrowers will have invested in their homes and the more likely it is that they may default on mortgage obligations, especially during times of economic hardship or price depreciation in the housing market.

Question. Your testimony notes that FHA has generally underestimated the subsidy costs for its single-family program based on the annual re-estimates it conducts. In fact, FHA had a $7 billion re-estimate in 2003 due to various reasons.

Given this history, what level of confidence do you have that FHA's credit subsidy estimate for fiscal year 2008 is accurate? Is it unreasonable to assume that the credit subsidy situation is worse than projected by FHA? Do you believe that the credit subsidy estimate for fiscal year 2007 may change?

Answer. Although credit subsidy estimates by their nature have a degree of uncertainty, FHA's estimates, including those for fiscal year 2008, should be viewed with particular caution given the agency's track record. In recent years, FHA has taken a number of steps to improve its subsidy estimates such as including the source of down payment and borrower credit scores in its loan performance models (the results of which are used to estimate credit subsidy costs). However, FHA's current reestimates of subsidy costs are generally less favorable than the original estimates, even for recent books of business. For example, the current reestimated cost for the fiscal year 2006 book of business is about $800 million higher than originally estimated.

Annual estimates of a program's lifetime credit subsidy costs can change from year to year as a result of changes in estimation methodology, economic assumptions, and program policies. Furthermore, each additional year provides more historical data on loan performance that may influence subsidy estimates. As a result, it is likely that FHA's credit subsidy estimate for fiscal year 2007 (and for other years) will change to some degree. However, it is difficult to predict the size and direction of those changes.

QUESTION SUBMITTED BY SENATOR ARLEN SPECTER

Question. According to GAO's analyses, will FHA's modernization proposals make FHA more financially sound? What is the most crucial change for FHA to implement to improve its risk management?

Answer. As we reported in June 2007, FHA has estimated that its three major legislative proposals (instituting risk-based pricing, raising loan limits, and lowering down-payment requirements) would have a beneficial impact on HUD's budget due to higher estimated negative subsidies.[9] According to the President's fiscal year 2008 budget, the credit subsidy rate for FHA's Mutual Mortgage Insurance Fund (which supports FHA's single-family insurance programs) would be more favorable if the legislative proposals were enacted. Absent any program changes, FHA estimates that the Fund would require an appropriation of credit subsidy budget authority of approximately $143 million. If the legislative proposals were not enacted, FHA would consider raising premiums to avoid the need for appropriations. If the major legislative proposals were passed, FHA estimates that the Fund would generate $342 million in negative subsidies. Although credit subsidy estimates by their nature have a degree of uncertainty, FHA's estimates, including those for fiscal year 2008, should be viewed with particular caution given the agency's track record. FHA's current reestimates of subsidy costs are generally less favorable than the original estimates, even for recent books of business. For example, the current reestimated cost for the fiscal year 2006 book of business is about $800 million higher than originally estimated.

A major reason why FHA has estimated a need for appropriations in fiscal year 2008 (absent program changes) is the poor performance of loans with down-payment assistance from nonprofits that receive funding from property sellers. Accordingly, we believe it is critical that FHA develop sufficient standards and controls to manage the risks associated with these loans. These loans are problematic because property sellers that provide down-payment assistance through nonprofits often raise the sales prices of the homes involved in order to recover the required payments to the nonprofits. For example, in November 2005, we reported that FHA-insured homes bought with seller-funded nonprofit assistance appraised at and sold for about 2 to 3 percent more than comparable homes bought without such assistance.[10] The weaker performance of loans with seller-funded down-payment assistance may be

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[9] GAO, Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvements in Risk Management, GAO–07–708 (Washington, DC: June 29, 2007).

[10] GAO, Mortgage Financing: Additional Action Needed to Manage Risks of FHA-Insured Loans with Down Payment Assistance, GAO–06–24 (Washington, DC: Nov. 9, 2005).

explained, in part, by the higher sales prices and the homebuyer having less equity in the transaction.

Our 2005 report made recommendations designed to better manage the risks of loans with down-payment assistance generally and from seller-funded nonprofits specifically. We recommended that FHA consider risk mitigation techniques such as including down-payment assistance as a factor when underwriting loans. We also recommended that FHA take additional steps to mitigate the risk associated with loans with seller-funded down-payment assistance, such as treating such assistance as a seller inducement and therefore subject to the prohibition against using seller contributions to meet the 3 percent borrower contribution requirement. Consistent with the first recommendation, FHA is testing additional predictive variables, including source of the down payment, for inclusion in its mortgage scorecard (an automated tool that evaluates the default risk of borrowers). Additionally, HUD has proposed a rule to prohibit seller-funded down-payment assistance. However, implementation of the rule has been delayed due to a legal challenge from certain nonprofit down-payment assistance providers.

SUBCOMMITTEE RECESS

Senator MURRAY. Thank you to all of you for coming forward today and your testimony. It's been very helpful to this committee. With that, this subcommittee will stand in recess, subject to the call of the Chair.

[Whereupon, at 10:50 a.m., Thursday, March 15, the subcommittee was recessed, to reconvene subject to the call of the Chair.]