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**Written Testimony of Shaun Donovan
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Development (HUD)**

**Hearing before the U.S. Senate Appropriations Committee
Subcommittee on Transportation, Housing and Urban
Development
on
FHA and the Future of the Housing Market**

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INTRODUCTION

Chairwoman Murray, Ranking Member Collins, and Members of the Subcommittee, thank you for the opportunity to testify today regarding the Federal Housing Administration, in the context of HUD's proposed fiscal year 2012 Budget, and also with respect to the FHA's key role in the Obama Administration's efforts to both address the foreclosure crisis and to reform America's housing finance market.

I was pleased to have the opportunity to testify before this subcommittee on March 6, 2011 to discuss in detail the Department's 2012 budget, *Creating Strong, Sustainable, Inclusive Communities and Quality Affordable Homes*. As you know, the Budget proposal works to "win the future," and I look forward to discussing with you in my testimony how the FHA will play a central role in that effort.

I would be remiss if I didn't say a few words about David Stevens, the recently departed FHA Commissioner. Dave brought to the job a unique blend of private sector expertise and commitment to providing underserved communities access to our programs. The strong team that Dave and I were able to put in place was instrumental to ensuring that, in the midst of the worst economic crisis in decades, FHA was able to fill the gap left by the retreat of private capital, while also significantly strengthening the FHA's financial position and toughening enforcement. I am delighted that Robert Ryan, our Deputy Assistant Secretary for Risk Management and Regulatory Affairs, will be serving as Acting Assistant Secretary for Housing and FHA Commissioner. While I anticipate the naming of a permanent Commissioner in the near future, I would like to

assure the subcommittee that under Bob Ryan's leadership, there will be continuity in FHA's operations, based on the strong foundation laid down by Dave Stevens, including the bipartisan approach he consistently followed.

OVERVIEW OF HUD'S FISCAL YEAR 2012 BUDGET

As I discussed when I last appeared before the subcommittee, we are in an economic environment that is significantly improved from when the President took office. An economy that was shrinking is growing again - and instead of rapid job loss, more than 1.8 million private sector jobs were created in the last thirteen months, including 230,000 private sector jobs in March. But we know there's still more work to be done to ensure that America and its workers can compete and win in the 21st century. And we have to take responsibility for our deficit, by investing in what makes America stronger and cutting what does not, and in some cases making reductions in programs that have been successful.

HUD's Fiscal Year 2012 budget tackles these challenges head on: by helping responsible families at risk of losing their homes and by providing quality affordable rental housing; by transforming neighborhoods of poverty to ensure we are not leaving a whole generation of our children behind in our poorest communities; by rebuilding the national resource that is our federally-assisted public housing stock and ensuring that its tenants are part of the mobile, skilled workforce our new global economy requires, and by leveraging private sector investments in communities to create jobs and generate the economic growth we need to out-innovate, out-educate and out-build the rest of the world.

As a down payment toward reducing the deficit, the President has proposed a freeze on non-security discretionary spending for the next five years, cutting the deficit by \$400 billion over 10 years and bringing this spending to the lowest share of the economy since President Eisenhower. HUD's fiscal year 2012 budget more than meets the President's goal - the Department's net budget authority of \$41.7 billion is 2.8% below the fiscal year 2010 actual level of \$42.9 billion. To maintain this commitment to fiscal discipline, we have protected existing residents and made the difficult choice to reduce funding

for new units and projects, including cuts to the Community Development Block Grant, HOME Investment Partnerships, and new construction components of the Supportive Housing Programs for the Elderly (Section 202) and Disabled (Section 811).

As discussed in more detail below, this budget balances the need for FHA and Ginnie Mae to continue supporting the housing recovery in the year ahead and ensuring that underserved borrowers have access to homeownership, with affirmative steps to encourage the return of private capital to the housing market. I want to thank the members of the Subcommittee for working with your colleagues to enact legislation (H.R. 5981) in the last Congress to reform FHA's mortgage insurance premium structure. With this authority, FHA announced a premium increase of 25 basis points last month. Because of these reforms and others, the current President's Budget reflects estimated FHA offsetting budgetary receipts of \$9.8 billion in FY 2011, which will reduce the Federal deficit. This is far more than the \$5.8 billion originally estimated by the Administration for the current fiscal year. These changes are largely due to the premium increase and the policy changes we have made since the President's Budget was published last February. While the ultimate receipts for FY 2011 are subject to fluctuations in loan volume, FHA is on track to outpace both of these figures in the current fiscal year. Furthermore, in FY 2012, the President's Budget projects FHA and GNMA to generate, collectively, over \$6 billion in receipts that will help to rebuild the FHA's capital reserves and offset the Department's gross budget authority request of \$47.8 billion.

I am pleased to note that, as the members of the Subcommittee are no doubt aware, the CBO estimate of these offsetting budgetary receipts in Fiscal Year 2012 are quite close to those reflected in the President's Budget - the magnitude of difference between CBO's estimate and the President's Budget for FY 2012 is significantly smaller than in previous years at approximately \$300 million. I am hopeful this new estimate will make the development of the Fiscal Year 2012 HUD appropriations bill - a challenging task in any year, and particularly so in the current fiscal climate - somewhat more manageable. I look forward to working with the members of the subcommittee in that effort.

Lastly, because winning the future also means reforming government so it is leaner, more transparent, and ready for the 21st century, we are also continuing to reform the administrative infrastructure that oversees our programs. For example, the Transformation Initiative - important funding and programmatic flexibility Congress provided beginning in 2010 - is enabling HUD to establish the FHA Transformation project, which will give FHA cutting-edge, modern financial services IT systems.

RESPONDING TO THE EVOLVING HOUSING CRISIS

Before describing in detail FHA's 2012 budget and the future of the housing market in which FHA will continue to play a central role, I believe it is important to take a brief look at the response of HUD and the Administration as a whole to the housing crisis, both in its early stages and today.

In the face of an economic crisis that experts across the political spectrum predicted could turn into the next Great Depression, the Obama Administration had no choice but to step in with a plan to aggressively confront the economic crisis as soon as we took office, including taking steps to stabilize the housing market. The Federal Reserve and Treasury helped keep mortgage interest rates at record lows with combined mortgage-backed securities (MBS) purchases of almost \$1.5 trillion. Because low interest rates only matter if there are mortgages available at those rates, the Administration also provided critical support for Fannie Mae and Freddie Mac, while the FHA and Ginnie Mae stepped in to play critical countercyclical roles in helping to stem the crisis and enabling a robust refinancing market to emerge.

As reported in the Obama Administration's March Housing Scorecard, since April 2009, nearly 13 million homeowners have been able to refinance their mortgages to benefit from lower interest rates, saving them an average of \$140 per month or \$17.6 billion annually. In addition, the Administration proposed, and Congress enacted, a homebuyer tax credit to spur demand in the devastated housing sector. We also took significant steps to help families keep their homes - through mortgage modifications and FHA's loss mitigation efforts.

The results of these extraordinary actions are clear. Since April 2009, more than 4.4 million borrowers have received restructured mortgages, including more than 1.5 million Home Affordable Modification Program (HAMP) trial modification starts, more than 775,000 FHA loss mitigation and early delinquency interventions, and more than 2.1 million proprietary modifications under HOPE Now - more than twice the number of foreclosures completed in that time. Today, monthly foreclosure starts are down more than 30,000 per month from this same time one year ago. I would note that while the sharp decline may be partially attributed to servicer process reviews in light of foreclosure processing deficiencies, the number of homeowners entering delinquency in the first place was down significantly even before these reviews began. That said, this number may trend upwards as servicers revise and resubmit foreclosure paperwork in coming months,

Additionally, FHA and HUD recently launched two programs to address the two most pressing problems facing the housing market, negative equity and unemployment.

- In September 2010, the Federal Housing Administration launched the FHA Short Refinance Option to assist non-FHA borrowers to refinance their underwater mortgages into sustainable fixed rate, FHA-insured mortgages. This option provides an additional opportunity for lenders to voluntarily offer principal writedowns and restructure loans for some families who owe more than their home is worth. To date, more than 400 applications have been submitted by a wide diversity of lenders and four large servicers have announced that they are finalizing development of the infrastructure that is required to participate in this program and voluntarily offer principal writedowns to select underwater borrowers, which will benefit homeowners by reducing their monthly payments and addressing negative equity, while also significantly reducing the investors' risk of default.
- As part of the Dodd-Frank Wall Street Reform Act, Congress provided HUD authority and funds to assist unemployed and underemployed homeowners struggling to make their mortgage payments via the Emergency Homeowner Loan Program (EHLPP). Last week, HUD announced that five states - Connecticut, Delaware, Idaho, Maryland, and Pennsylvania - have been approved to provide a combined total of almost \$200 million of assistance from these funds. These

states are expected to be ready to accept applications as soon as next week to help eligible residents in these states. HUD continues to responsibly develop additional components of the program to serve the remaining 27 states that have been awarded EHP funds, and we will announce additional details and program specifics for these states in the coming weeks.

FHA's FISCAL YEAR 2012 BUDGET

The number of borrowers who depend on FHA for access to mortgage financing has increased greatly during this economic recovery as access to private capital has contracted in the recent difficult economic period. In Fiscal Year 2012, HUD is requesting \$400 billion in loan guarantee authority for the Mutual Mortgage Insurance Fund, which will provide an estimated 1.2 million single family mortgages. In addition, HUD is requesting \$25 billion in loan guarantee authority for the General and Special Risk Insurance Fund, which will enable FHA to insure an estimated 190,000 units in multifamily housing properties and an estimated 98,000 beds in healthcare facilities.

As housing markets continue to be stressed, FHA is taking on business that is resulting in a portfolio of historically high borrower credit quality. These new loan guarantees and mortgage insurance premiums that they generate are providing net income that can be used both to offset claim expenses on the earlier books and to start rebuilding FHA's capital position.

FHA Multifamily Mortgage Insurance

With more than one-third of all American families renting their homes, during this time of economic hardship for so many it is more important than ever to provide a sufficient supply of affordable rental homes for low-income families. Multifamily mortgage insurance programs make critical contributions toward the Department's mission of creating strong, sustainable, inclusive communities and quality affordable homes for all by expanding the supply of rental housing in areas where they are most needed, and by preserving the affordability and quality of both federally assisted and private unassisted rental housing. The role of FHA's multifamily mortgage insurance programs is especially significant in the current economic climate.

Driven by low interest rates, more constrained lending in the conventional mortgage market, and improvements in HUD business operations, demand for FHA multifamily programs has increased dramatically. At this time of unprecedented stress in the financial markets, FHA Multifamily programs provide necessary liquidity so that apartment construction and rehabilitation can continue. FHA financing is often paired with low-income housing tax credits, rental subsidies for low- and moderate-income families, tax-exempt bond financing, and/or other state and local resources to expand the offering of affordable units in areas where they are needed most. Multifamily mortgage insurance programs also contribute significantly to local revitalization efforts and economies by providing liquidity to uniquely sustainable projects located in centers of job growth, near transportation and other community opportunities.

In 2008, FHA supported the development of about 49,000 rental homes. Now, however, conditions are very different, reflecting the sharp decline in fully private financing and most notably commercial mortgage-backed securities. In 2010 alone, FHA supported the development or refinancing of more than 150,000 rental units with a total dollar volume of nearly \$11 billion - almost four times the level of two years earlier, and now almost 25 percent of the multifamily market. This activity is projected to increase further to \$13.1 billion in 2011 and to be at a level of \$12.8 billion in 2012. HUD estimates that these construction volumes will support up to 85,000 direct jobs annually.

I'd like to thank Congress for passing legislation last summer - H.R. 5872, the General and Special Risk Insurance Funds Availability Act of 2010 - to increase FHA's commitment authority for our multifamily and healthcare facilities insurance programs. This was a key step to help facilitate the continued production and refinancing of multifamily properties and healthcare facilities. To ensure that these programs continue to operate responsibly despite the unprecedented demand, FHA simultaneously implemented the most significant reforms to its multifamily programs to strengthen underwriting guidelines and minimize financial risk to taxpayers while providing this critical support.

FHA Insured Healthcare Facilities

In fiscal year 2011, FHA is continuing to provide critical support to enable the construction and refinancing of acute care hospitals, skilled nursing, assisted living, and board and care facilities. Additionally, these projects contribute to stimulating the local community economy where the project is based as well, expanding employment, and reducing health care capital costs. In FY 2010, seventeen hospital facilities received commitments to advance their mission in communities throughout the country. For FY10, the total construction expenditures for all hospital commitments amounted to \$1.4 billion, which HUD estimates will result in 15,465 new direct jobs that will be created during construction, with \$3.9 billion of overall economic benefit. Following construction, FY10 projects will generate estimated annual new economic activity of \$1.4 billion and 8,464 new jobs.

Demand for Section 232 Residential Care Facilities (Skilled Nursing, Assisted Living and Board and Care Facilities) has also increased. FHA considered 347 applications and issued commitments for 318 facilities in FY 2010. As of March 18, 2011, an additional 241 insurance commitments have already been issued in FY 2011 for 232 program applicants serving the senior housing market. Through LEAN processing methods and high productivity from FHA staff members, this industry-generated volume is being addressed as responsibly as possible given staffing and capacity constraints.

Home Equity Conversion Mortgages (HECM)

In October, FHA launched the HECM Saver product. Designed as a second reverse mortgage option for senior home owners to tap into their equity, the HECM Saver product has lower upfront loan closing costs and is optimal for homeowners who want to borrow a smaller amount than that which would be available with a HECM Standard loan.

mortgage insurance premium for both *HECM Saver* and HECM Standard is charged monthly at an annual rate of 1.25 percent of the outstanding loan balance. The 2012 President's Budget estimates that these two programs will generate \$304 million in receipts.

Borrowers using the Saver option have access to home equity in amounts that are between 10 and 18 percent less than would be available with the HECM Standard option. The reduction equity take-out for Saver substantially lowers risk to the FHA insurance Fund, and thus permits the virtual elimination of the upfront premium charge.

HECM Standard remains as an option for senior home owners who need to tap the highest possible home equity to cover living expenses and/or health care costs, while continuing to live in their homes without having to make the mortgage payments required with a traditional mortgage or home-equity loan.

Transformation Initiative

Winning the future means reforming government so it's leaner, transparent, and ready for the 21st century. While HUD programs already make a significant difference in the lives of ordinary Americans, this Administration is also committed to making government more efficient, more effective and more accountable. The FY 2012 Budget provides up to \$120 million for the Transformation Initiative (TI) Fund to support cutting edge research and demonstrations and technical assistance to our partners. In fiscal year 2010, thanks to the TI Fund, HUD began to fundamentally alter how we approached our investments in delivering technical and capacity-building assistance, conducting research demonstrations, and maintaining and upgrading our IT systems so that we can hold ourselves and our local partners accountable for the outcomes needed to achieve the Department's strategic goals.

21st Century Technology to Protect the Taxpayer's Investment

In fiscal years 2010 and 2011, IT investments constituted the largest share of proposed Transformation Initiative project funding. \$122.5M was allocated for IT in FY 2010 and \$119M was requested in FY 2011. The Department's careful investment planning has prepared us to act responsibly to modernize our use of IT to meet today's mission challenges. Our intent is to fully leverage these resources to meet our transformation needs. Additional funding was not requested in FY2012 on the presumption that sufficient funding would be available to support these

projects for fiscal year 2012, between prior year TI funding and the Working Capital Fund.

One of the top priority IT projects is the FHA Transformation project, which involves the development of a modern financial services IT environment to better manage and mitigate counterparty risk across all of FHA's Insurance Programs. The new tools will minimize the exposure of our Insurance Funds and support the restoration of the capital reserve ratio to Congressionally mandated levels by enabling risk detection, fraud prevention and the capture of critical data points at the front-end of the loan lifecycle. More simply put, FHA Transformation will enable HUD to identify trends, and seamlessly take action, before problems occur. This approach will protect consumers and the economy by ensuring that lenders adhere to safe underwriting standards. Importantly, FHA Transformation will also allow HUD to start the careful process of migrating relevant portions of our legacy applications, most of which were built in a 1970's era programming language, to a more cost-effective platform.

In addition to prior year TI fund transfers, in Fiscal Year 2012 HUD will utilize \$315 million in Working Capital funding to support HUD's transformation efforts, providing resources for the development of, modification to, and infrastructure for Department-wide information technology systems.

Housing Counseling Assistance

Each year, HUD awards grants to hundreds of local counseling agencies and State Housing Finance Agencies that offer a variety of services, which are especially critical in today's economic climate. HUD-approved counselors help clients learn how to avoid foreclosure, how to purchase or rent a home, how to improve credit scores, and how to qualify for a reverse mortgage. In 2009, HUD assisted over 2.5 million families through its housing counseling program, including 1.58 million potential and current homeowners with issues pertaining to mortgages and financing of their homes. In 2010, HUD awarded \$79 million for housing counseling grants, a 27 percent increase over its 2009 funding.

In Fiscal Year 2012, HUD is requesting \$88 million in Housing Counseling Assistance. The primary benefits of the program are to expand homeownership opportunities, improve access to affordable housing and preserve homeownership. With this level of funding, HUD anticipates serving as many as 318,187 low- to moderate-income families, as well as training approximately 4,400 counselors

Salaries and Expenses: Flexibility to Respond in a Crisis

As the Subcommittee knows, HUD's salaries and expenses budget is divided into multiple sub-accounts, with limited transfer and reprogramming flexibility. While the Department has once again submitted this portion of the budget proposal in that structure, recent FHA and Ginnie Mae staffing needs have illustrated the challenges of proposing a personnel plan a full year and a half prior to the onset of the fiscal year. Events, including developments related to the housing crisis, can intervene and the Department needs the flexibility to respond. Accordingly, I hope that we can work with the Subcommittee to strike an appropriate balance between the need for transparency and oversight of HUD's salary and expenses expenditures, and this need to be able to respond nimbly to changing circumstances.

In the FY 2012 budget, we have proposed to restructure the Executive Direction account by removing sub-function allocations to provide the Department with the flexibility needed to respond promptly to emerging issues or unanticipated needs as they arise throughout the year. Moreover, we would like to explore with your committee, the possibility of providing additional administrative flexibilities in accounts funding salaries and expenses across the Department. Over the past two years, it has become clear to us that the administrative burden and lack of flexibility afforded by the current structure outweighs the potential management benefits.

Ginnie Mae Budget Request for Salaries and Expenses as a Model

Our budget request with respect to Ginnie Mae's staffing needs, provides an example of the kind of flexibility that can be achieved to enable greater capacity, service, and protection to taxpayers, without requiring additional

appropriations. In light of Ginnie Mae's vastly increased market share (from 4% to over 30% in the past few years) and a guaranty portfolio that now tops \$1 trillion, the FY 2012 request proposes to fund its personnel expenses through Commitment and Multiclass fees rather than through a separate appropriation for personnel compensation and benefits. This will allow GNMA to increase its staff level to strengthen risk management and oversight, and to move in-house some functions that are performed by contractors.

Our Budget proposal affords Ginnie Mae more flexibility in funding its critical personnel and administrative needs. Importantly, the Congress will retain its role in determining annual Ginnie Mae funding. However, with receipts accumulating in Ginnie Mae's program account, a ready source of funding will be available to help the agency fund both current needs along with contingencies that may arise in the future. In addition, the Budget allows Ginnie Mae to increase the amount for salaries and expenses if its volume of guaranty commitments rises above a specified level. The Budget proposes to allocate \$100 for salaries and expenses for each \$1 million of guaranty commitments exceeding \$300 billion. As Ginnie Mae's role in the housing finance market continues to grow, it is critical that the agency have this additional flexibility to be able to respond to market needs. This proposal positions Ginnie Mae to continue to effectively and responsibly bring global capital into the American housing finance system.

With respect to FHA, we have requested a significant increase in staffing in the FY 2012 budget - 92 additional FTEs compared to fiscal year 2010 enacted levels.

REVIEW OF FHA'S FINANCIAL CONDITION

Results from FHA Reforms to Date

As you know from the Secretary's Annual Report to Congress on the Financial Status of the FHA Mutual Mortgage Insurance (MMI) Fund at the end of FY 2009, the secondary reserves held in FHA's Capital Reserve Account to support single-family loan guarantees had fallen below the required two percent level - to 0.53 percent of the total insurance in-force. At the same time, total reserves held in the Capital and the Financing Accounts at that time were at an historical high of more than \$31 billion. Total reserves

grew again to over \$33 billion in FY 2010. These funds are available to cover potential future losses on outstanding loan guarantees. The independent actuarial study for FY 2010 indicated that these would be sufficient for even a stressed scenario of loan performance over the next five years. Even prior to the release of the FY2009 actuarial review that indicated capital reserves had fallen below the statutory threshold, we took several steps to strengthen the Fund. Today, I am pleased to inform you that tangible, measureable progress has been achieved and we continue to see improvements in the financial condition of the Fund, while holding lenders more accountable, and reducing risk to taxpayers.

Making that progress required FHA to put in place the most sweeping combination of reforms to credit policy, risk management, lender enforcement, and consumer protection in the agency's history. These reforms have strengthened its financial condition and minimized risk to taxpayers, while allowing FHA to continue fulfilling our mission of providing responsible access to homeownership for first-time homebuyers and in underserved markets.

Specifically, FHA implemented a "two-step" credit score policy for FHA borrowers. Those with credit scores below 580 are now required to contribute a minimum down payment of 10 percent, or have equity of 10 percent at the time of refinance. Only those with stronger credit scores are eligible for FHA-insured mortgages with the minimum 3.5 percent down payment.

To balance the need to provide access to our mortgage markets with the need to protect taxpayers from financial risk, we established FHA's first Office of Risk Management. With this new office and additional staffing, FHA is expanding its capacity to assess financial and operational risk, perform more sophisticated data analysis, and respond to market developments.

Further, FHA has strengthened credit and risk controls - toughening requirements on FHA's Streamlined Refinance program, making several improvements to the appraisal process and to condominium policies, and implementing the two-step credit score policy discussed above. We are very grateful for the support that Congress has provided to our efforts to reduce fraud and risk. Through the \$20

million Combating Mortgage Fraud funds that Congress granted HUD in FY2010, we have begun to implement several risk management and systems modernization reforms to incorporate modern risk and fraud tools and counterparty data consolidation. Additionally, FHA introduced policy changes and improved lender oversight and enforcement to increase the quality of FHA insured loans.

As a result of these actions, FHA finds itself in a stronger position today. In particular:

- The quality of loans endorsed in 2009 and 2010—the years FHA has done the most significant volume—is much improved. FY 2010 is the highest quality FHA book-of-business on record, and FY 2011 may prove to be even better.
- The credit-score distribution for new insurance continues to improve. The average credit score on current insurance endorsements has risen to 700. And in the second half of CY 2010, average credit scores were equally strong across refinance and purchase books-of-business.
- Loan performance, as measured by early period delinquency and by seasonally-adjusted serious delinquency rates, continues to show significant improvement from the high rates experienced in 2007 and 2008.⁽¹⁾
- FHA's seasonally-adjusted 90+ day delinquency rate in December 2010 was 5.8%, compared to 7.45% in December 2009.

Summary of FY 2010 Actuarial Review

Total capital resources (combined Capital Reserve Account and Financing Account) in FY 2010 increased by \$1.5 billion to \$33.3 billion. At the same time, the overall capital ratio held steady at 0.5% reflecting that more conservative economic forecasts and model changes offset the benefits of improved borrower credit profiles and increased premium income. On a standalone basis, had capital resources not been shifted from the forward loan accounts to HECM accounts to cover HECM budget re-estimates, the capital ratio of single-family forward loans (96% of the portfolio) would have increased from 0.42% in FY 2009 to 0.79% in FY 2010, demonstrating significant improvement in loan quality and underlying reserves. Without any additional policy actions, and incorporating conservative economic forecasts, the capital ratio for the entire MMI

Fund is projected by the independent actuaries to exceed the 2% statutory requirement early in 2015. Furthermore, we have implemented a wide range of additional policy actions that are expected to strengthen the Fund even more quickly than forecasted.

While we are not yet completely out of the woods based on the evidence we're seeing, FHA is weathering the economic storm. And we're doing so, Madam Chairwoman, while simultaneously reducing financial risk to taxpayers and helping to create a firm foundation for the recovery of the housing finance system.

The Need for FHA Reform Legislation

As discussed, within the existing authorities granted to us by Congress, we have already begun the necessary process of making changes to FHA to ensure that it will be able to continue its mission. Moving forward, we look to Congress to pass FHA reform legislation that enhances our lender enforcement capabilities and risk management efforts that are critical to our ability to monitor lender performance and ensure compliance, among other things. Indeed, last year the House of Representatives passed an FHA reform bill, H.R. 5072, containing an array of changes along these lines, and, while similar legislation was introduced in the Senate, action on the bill was not completed. I urge Congress to make passage of legislation along these lines a top priority in the 112th Congress. In addition to provisions strengthening FHA's lender enforcement ability, the 111th Congress bill also included technical clarifications that will allow third party loan originators to close FHA insured loans in their name. This third party originator provision is particularly important to ensuring that several hundred community banks are able to continue originating FHA loans. Additionally, HUD is seeking Congressional authority to extend FHA's ability to hold all lenders to the same standard and permit FHA to recoup losses through required indemnification for loans that were improperly originated and for which the error may have impacted the original loan decision, or in which fraud or misrepresentation were involved. We also hope to work with Congress to give FHA additional flexibility to respond to stress in the housing market and to manage its risk more effectively. This will mean giving FHA flexibility to adjust fees and programmatic parameters more nimbly than it can today.

FHA should also have the technology and talent needed to run a world-class financial institution.

THE FUTURE OF HOUSING FINANCE

Toward a New System of Housing Finance

Despite all of the efforts to date, there is much more to do. We must continue to take steps to facilitate the return of private capital to the housing finance system in a responsible way. Last summer, Congress passed, and the President signed, sweeping financial reform legislation. Crucially, the Dodd-Frank Wall Street and Consumer Protection Act, provides vital protections for consumers and investors that will help end abusive practices in the mortgage market and improve the stability of the overall housing finance market.

In keeping with our obligations under Dodd-Frank, the Obama Administration recently delivered a report to Congress, *Reforming America's Housing Finance Market*, which provides a path forward for reforming our nation's housing finance system. The report outlines steps that will be taken to wind down Fannie Mae and Freddie Mac and help bring private capital back to the market in a first loss position. Moreover, it describes how to fix fundamental flaws in the mortgage markets and better target the government's support for a full range of housing that is affordable for its occupants, and lays out choices for longer-term reforms.

Bringing private capital back into the housing finance system does not mean eliminating all government involvement in housing finance. We believe that a government role, targeted correctly, and with the right protections for taxpayers, should remain an important component of any future system. That is why all three of the reform options we lay out in the white paper include a strong, resilient FHA and solid consumer and investor protections.

To that end, reforming and strengthening FHA is the first of four primary areas of reform to achieve a system with transparent and targeted support for mortgage access and housing affordability. The other crucial components of reform are a commitment to affordable rental housing, a flexible and transparent funding source for access and

affordability initiatives, and strong measures to ensure that ensure that capital is available to creditworthy borrowers in all communities, including rural areas, economically distressed regions, and low-income communities.

The Importance of a Robust and Responsible Private Mortgage Market

Today, FHA is the largest insurer of mortgages in the world, with a portfolio that today exceeds \$1 trillion, and a history that includes insuring over 39 million home mortgages and 52,000 multifamily project mortgages since 1934.

But a critical component to further recovery of the broader economy, and to reducing the financial risk to taxpayers, is to facilitate the return of private capital to the housing finance system in a responsible way. This was a central goal of the Administration's recently released report on *Reforming America's Housing Finance Market*, which proposed to wind down Fannie Mae and Freddie Mac, fix fundamental flaws in the mortgage markets, make the government's support for affordable housing explicit and better targeted, and provide choices for longer-term reforms. The return of private capital is particularly important given that today, Fannie Mae, Freddie Mac, FHA and Ginnie Mae collectively insure or guarantee more than nine out of every ten new mortgages.

During the height of the housing boom in 2006, FHA-insured mortgages constituted less than 4 percent of the number of new home purchases. This was a significant decrease from FHA's historically traditional share of approximately 10-15 percent, and an indication that the private sector was aggressively extending credit. All too painfully, we learned that this extension was often irresponsible. As poorly underwritten subprime loans and other products that were securitized into private label securities (PLS) began to default at an alarming rate, their defaults led to losses throughout the private market and private capital vanished from the housing sector at an unprecedented pace - in 2006, more than \$1 *trillion* of such mortgages were securitized into PLS; in 2010, that figure was less than \$60 *billion*⁽²⁾.

FHA's temporarily elevated market share of more than 20 percent of the overall loan volume (home purchases and refinances) is the result of our efforts to fulfill our mission to be a countercyclical facilitator of responsible capital liquidity in the housing sector at times when the private sector exits the market abruptly. As the Subcommittee knows, FHA does not lend directly to homeowners, but instead insures lenders against losses that may result in the event of a borrower default, under the condition that lenders are required to abide by extensive documentation and underwriting guidelines to originate sustainable mortgages, as well as providing numerous loss mitigation opportunities to help borrowers avoid default or foreclosure.

The most recent data shows that 60 percent of African American and Latino homebuyers purchase homes with FHA backing.⁽³⁾ FHA thus plays a vital role in opening up access to homeownership for the underserved in our country.

A Reformed and Strengthened FHA

Strengthening and reforming FHA in a way that is healthy for its long term finances and ensures that FHA is able to continue its mission of providing access to mortgages for low- and moderate-income families is a central component of broader systematic reforms. While FHA has already changed policy to require that borrowers with lower FICO scores make larger down payments, FHA will consider other options, such as lowering the maximum loan-to-value ratio for qualifying mortgages more broadly. In considering how to apply such options, FHA will continue to balance the need to manage prudently the risk to FHA and the borrower with its efforts to ensure access to affordable loans for lower- and middle income Americans, including providing access to homeownership for first-time homebuyers and underserved markets.

FHA will take any steps for reform carefully to ensure that they do not undermine the broader recovery of the housing market. Similarly, as we consider changes in such areas as down payments and LTV ratios, we will make sure to retain the flexibility to respond to changing market conditions, so

that we are able to manage risk, and maintain access, as effectively as possible.

Some have expressed concerns that the increases to the monthly premium set to go into effect next month-on the order of \$30 per month for the typical home-purchase borrower-and any increase in down payment requirements have the potential to excessively restrict access to credit or perpetuate a dual credit market. We believe that the benefit to the financial health of FHA of the relatively modest premium increase is appropriately balanced with the need to maintain access, as the change remains affordable for almost all homebuyers who would qualify for a new loan. Similarly, we will strongly consider the impact on access with any proposal to increase down payment requirements..

Proposed Rule for Qualified Residential Mortgage

Last month, HUD joined with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, the Federal Reserve, and the Securities and Exchange Commission to announce the consideration and release of their Notice of Proposed Rulemaking ("NPR") for Section 941 of the Dodd-Frank Act, which sets proposed rules to implement the credit risk retention requirements for asset-backed securities and sets a 60 day comment period where all stakeholders are able to comment and provide feedback. Following this comment period, the rule writers will consider all comments received before releasing final rules.

The goal of the proposed rule is to provide clarity and rules of the road to the securitization markets. The proposed rule is one part of the Administration's goal of bringing private capital back into the housing finance system.

Getting this right is critical. With the financial crisis, we saw how bundling and packaging mortgages to sell on Wall Street with no accountability helped lead to the erosion of lending and underwriting standards that fed the housing boom and deepened the housing bust. The Dodd-Frank Wall Street Reform Act requires that securitizers or originators have 'skin in the game' by retaining at least 5 percent of the credit risk and the rule proposed today sets out options to accomplish that mandate.

Importantly, the rule seeks to define qualified residential mortgages - the loans that would not be subject to the risk retention requirements. Much debate will center on the size of down payments. While there is no question that larger down payments correlate with better loan performance, down payments only tell part of the story. That's why we have laid out two alternatives, one requiring a 10 percent down payment and another requiring 20 percent.

We look forward to comment from stakeholders on the relative merits of these choices, so that we strike the right balance between managing risk and maintaining access to safe, responsible homeownership.

CONCLUSION

Madam Chairwoman, between our budget request and the Obama Administration's proposals to reform the housing finance system, it is clear that FHA will continue to play a central role in the continued recovery of the housing market - particularly its ongoing commitment to provide access and affordability to low- and middle-income Americans. And as the reforms we have already made demonstrate, FHA has the capacity to perform this role in a way that minimizes risk to the taxpayer.

I look forward to working with this committee-and this Congress-to ensure that FHA has the tools it needs to fulfill that mission. Madam Chairwoman, thank you again for this opportunity to testify. I would be glad to respond to any questions.

¹ HUD's Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund FY 2010 can be found **online**

² Source: Inside Mortgage Finance, HMDA, and Mortgage Bankers Association

³ HUD analysis of 2009 Home Mortgage Disclosure Act data.