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TRANSPORTATION AND HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2011

THURSDAY, MAY 13, 2010

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

The subcommittee met at 9:32 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. DAVID H. STEVENS, COMMISSIONER

ACCOMPANIED BY KENNETH M. DONOHUE, INSPECTOR GENERAL

OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. Good morning. This subcommittee will come to order.

This morning we welcome Commissioner Stevens to his first appearance before our subcommittee as we examine the Federal Housing Administration and its role in the housing market.

As we sit here today, millions of Americans are out of work and many more are struggling with unaffordable mortgage payments, negative home equity, or foreclosure. During the housing boom, millions of Americans achieved the dream of home ownership, but for far too many Americans, these dreams were based on false premises and fueled by investors and lenders that were chasing profit while ignoring risk. The consequences of these risky behaviors have rippled through the national and global economies with mounting foreclosures, a crippled housing market, and a financial sector in turmoil. We continue to clean up the mess created by predatory lenders and Wall Street greed.

Fulfilling the same role as it did when it was created during the Great Depression, the FHA has stepped forward to help provide liquidity and restore stability to the housing market. FHA's increased role in the housing market is as critical as it is daunting. As recently as 2007, when this subcommittee held the first in a series of annual hearings on FHA, its share of the market was only 3 percent. Today FHA represents nearly 30 percent of all new home sales. FHA has played a critical role supporting the housing market while private financing has been nearly frozen.

However, FHA has been plagued by longstanding management challenges, challenges that continue to raise concern about its ability to manage its outsized role in stabilizing the market. Commissioner Stevens, you have acknowledged the challenges you inherited when you took over the agency and have moved quickly to assess and seek solutions to the problems facing FHA. The most glaring of these are antiquated information technology systems and an inadequate workforce, both of which are critical to equipping the agency to meet the challenges that face us. A well functioning FHA is vital to maintaining the solvency of the Mutual Mortgage Insurance Fund and protecting the American taxpayers from having to pay for risky or fraudulent mortgages. This subcommittee provided additional resources to help FHA address its shortcomings both in 2009 and 2010. We provided funding to help FHA modernize its IT systems and hire additional staff to better manage and oversee a growing portfolio.

Equally important to these new tools is fostering a culture at FHA focused on risk. Commissioner Stevens, one of your first actions after taking office was to appoint FHA's first chief risk officer. This position was long overdue and sends an important signal to lenders, borrowers, and taxpayers that FHA understands the risks it faces and is working to mitigate them. I am pleased that the FHA is increasingly using its authority to investigate lenders that are not playing by the rules. It must be absolutely clear to lenders engaging in fraudulent and risky practices that they are not welcome in FHA programs and will not be supported by taxpayer dollars.

Despite some important progress, FHA still faces significant challenges. Foreclosures have taken their toll on FHA's finances, leaving the capital reserve fund below the 2 percent required by Congress. This is a cause for concern since any significant setbacks in the housing market could result in additional and possibly unaffordable losses to the fund.

In an effort to strengthen the agency's finances and protect itself from future risk, HUD has proposed a series of reforms, including increasing premiums, setting minimum FICO scores, increasing downpayment requirements for riskier borrowers, and expanding enforcement authorities. Some of these changes are already underway but others will require legislation.

Today I will have questions about these reforms, what they mean for fulfilling FHA's mission to provide access to affordable mortgages, as well as how they impact the solvency of the MMI Fund as we look to the future. It is clear that the solvency of the MMI Fund and the strength of FHA depend on the recovery of the housing market. This is evident by CBO's re-estimate of receipts that FHA is expected to generate in 2011. Continued uncertainty about the housing market, as well as lingering doubts about FHA's ability to realistically assess its risks, resulted in CBO's much more conservative estimate of $1.9 billion in receipts instead of the $5.8 billion projected by the administration.

The concerns expressed by CBO are real. Relatively stable home prices and increasing home sales suggests the market is stabilizing. Yet, large segments of the housing market remain fragile and there are looming problems that could undermine the progress we have made. Over 2 million homes are currently in foreclosure and that number is expected to grow through 2010.

To date, the administration's Home Affordable Modification Program has had limited success in stemming the tide of foreclosures. There have only been 230,000 permanent modifications made under this program far short of the 3 million to 4 million homeowners expected. And as banks and servicers determine whether a modification is in their best interest, many families are left waiting as they face the agonizing prospect of losing their home. I continue to hear that servicers are unresponsive to borrowers and in some cases unwilling to explain why modifications are denied. Americans trying to get assistance are frustrated and rightfully so. They have watched as banks have received billions of dollars in taxpayer assistance and yet many of these same banks are unwilling to assist homeowners facing foreclosure. This cannot be tolerated. Servicers must be held accountable. At the very least, servicers must communicate with those trying to receive assistance and provide an explanation if borrowers are not approved.

The success of HAMP was also limited because it failed to address two of the major problems facing troubled borrowers today: unemployment and negative equity. I have seen this tragic combination devastate families firsthand in communities across my State. In Clark, Snohomish, and Pierce Counties, communities are struggling with both unemployment and foreclosure, and unfortunately, home prices have yet to stabilize in Washington State, so families are continuing to see the equity of their homes decline. Nearly 16 percent of all Washington homeowners are under water and they are not alone. Over 11 million families in the country today are under water on their mortgages as a result of falling home prices and growing debt. That represents nearly one out of every four mortgages.

Just a few months ago, the administration announced plans to change HAMP in order to address these problems. The plans include offering increased relief for unemployed borrowers as they look for work and get back on their feet, as well as incentives for lenders to permanently write down the principal of these mortgages instead of addressing interest rates. These changes were necessary to more effectively address the foreclosure crisis, but I remain concerned that since this program is voluntary, it will fail to meet its goal.

So I expect the administration to compel lenders to provide real aid to families that want to and, with a fair deal, could stay in their homes. As part of these announcements, FHA's refinance program is also set to be expanded. This is an important tool that will assist homeowners to get into a truly affordable mortgage through incentives and write-downs of both first and second liens. While these loans will be subject to FHA underwriting standards, there is still an increased risk associated with those loans. In order to mitigate the effects of these riskier loans on the health of FHA's insurance fund, the administration has set aside $14 billion in TARP funds.

However, many of the details surrounding this proposal are still being worked out, and I am concerned this could result in additional losses to the MMI Fund, losses the fund simply cannot absorb. So I will have questions today about the design of this program and how we can be assured this program will not cost American taxpayers anything more than what was already set aside from the TARP funds.

Amidst all these efforts to modify mortgages so families can stay in their homes, there are a growing number of homeowners deciding to strategically default. Many of these homeowners can afford their mortgage payments, but because of the severe negative equity, they feel it is in their financial interests to simply walk away. The potential impact of this on home values and market stability would be devastating.

There is also the very real concern about what is called the "shadow inventory." These are houses that are facing foreclosure or have already been repossessed by the bank but are not yet on the market. Hopefully the impact of these will be lessened by an increase in permanent modifications, but if a large number of homes were to suddenly flood the market, all of our gains in home values could be erased.

These issues demonstrate how fragile the housing market remains, but we are beginning to test its stability. The Federal Reserve ended its purchase of mortgage-backed securities at the end of March and the homebuyer tax credit ended last month. Even as we watch with some anxiety as these supports are withdrawn, it is clear the Government cannot continue to play the outsized role in the housing market it has taken on over the past 2 years. The long-term health of the housing market and the economy depend on the return of the private market.

It is also clear we must address the future role of Fannie Mae and Freddie Mac in the housing market. There is no doubt that the GSEs had a hand in exasperating the housing crisis, and just as there needs to be consequences for Wall Street, there must also be consequences for the GSEs. The spigot of taxpayer dollars flowing into the GSEs cannot stay on indefinitely. As the administration debates the future of the GSEs, I like most Americans are growing impatient and my impatience only increases as the cost to the American taxpayers grows with no end in site.

The administration must put forward a real plan on how to reform the GSEs. GSEs currently provide important support to the housing market, and so this plan has to be thoughtfully done with care not to reverse the hard-won progress made to date. The plan must include a clear understanding of how any changes will impact the housing market and Americans' ability to buy a home for their families, but it is simply not enough to say it is complicated and we have a plan soon. It is not easy. It deserves an honest and open dialogue about its future, but there needs to be a sense of urgency that has been lacking so far.

As we try and tackle the complex set of challenges facing the housing market today, the Federal Government must play a role in supporting the market but it must also protect the taxpayers.

Commissioner Stevens, this has been your task since taking on the FHA, and I want to commend your commitment to addressing the challenges at FHA while working to ease the recovery of the housing market. I look forward to hearing your testimony today.

And with that, I turn it over to my partner and ranking member, Senator Bond, for his opening statement.

OPENING STATEMENT OF SENATOR CHRISTOPHER S. BOND

Senator BOND. Good morning, Madam Chair.

And thank you very much, Commissioner Stevens, for being with us today.

The chair has outlined the very significant problems that we have in the whole area of housing, not just in FHA, but I found her comments on the GSEs very similar to my concerns. We are in a real problem, and your efforts with FHA and your guidance on other things may be of help to us in trying to find a way out.

We are pleased to have on the front row Ken Donohue, the HUD inspector general. Over the years, he in particular has been a true partner working with me and others to eradicate fraud and abuse in the mortgage market. And that is not to diminish all the hard work both he and his staff perform in their oversight capacity in the Office of the HUD inspector general. This may be our last time to have a little gathering like this, Mr. Donohue, but you have my sincere thanks for being the uninvited guest at the garden party at so many of these hearings where you have had to tell the truth, and I am just lucky that you—we are both lucky that you did not get tarred and feathered for having warned us in advance of the problems we are facing. Now that we are seeing those problems, we can call you a guru, I guess, for having warned of many of the problems.

Well, with that beginning, Mr. Commissioner, as you know, FHA's history is marked by longstanding challenges in balancing the financial risk to FHA which we are seeing is significant and also very important is the goal of expanding home ownership, especially for low-income and first-time home buyers. This is the promise of FHA.

Unfortunately, much of the financial risk in the housing market, which is a risk to all of us as taxpayers, is uncertain. It is especially problematic since FHA still faces many challenges and is still evolving to limit FHA's financial exposure. Additional reforms we need to discuss, and I am still concerned the FHA is a powder keg that could explode, leaving the taxpayers on the hook for another bailout. To borrow the term from the gulf and the recovery efforts there, I think you are trying to put a cap on the well. We just hope it is more successful than the ones they have tried in the Gulf of Mexico.

As recently as 2007—okay, I stretched it a little bit. Okay, all right. I know when I get that look from the chair she is saying where is he going with this one. That is off the record. You can scratch that.

As recently as 2007, FHA accounted for less than 4 percent of the single family housing market, whereas FHA, as we all know, now dominates market with a share of about 30 percent of new mortgages and another 20 percent of refinances. While this market share may help the Federal oversight of home purchases, there is nothing predictable in FHA's enhanced role in the market for assessing the potential for financial risk to the FHA, the Mutual

Mortgage Insurance Fund, the MMIF that has already been referred to, and those of us as taxpayers.

There is no guarantee the housing market is on the rebound or that it will not collapse again, even though prospects are certainly more encouraging than they were a year ago. But with continuing high unemployment as well as the explosive and escalating Federal debt, I think the problems have not gotten much less severe. One of the essential questions we must ask is are we digging a grave with spending or filling one in.

As recently as late last year, FHA was unable to meet its statutory requirement of holding capital reserves equal to 2 percent of FHA's insurance in force. I am a born optimist and I could be optimistic that FHA will be able to meet this requirement in the future, but there remains wide disagreement as to the health of FHA's MMIF, with OMB's budget estimate for FHA receipts in 2011 at some $5.8 billion, as the chair indicated, which is about $4 billion more generous than the CBO's re-estimate. This disparity both underlines the unpredictability in the future of the overall housing market, as well as uncertainty as the financial risk to FHA's single family mortgage insurance programs.

The CBO re-estimate also means we will likely have to tighten our belts with regard to other programs within the jurisdiction of the THUD appropriations subcommittee. Let me assure you that others coming in here before us have grand schemes of how much money they want to spend, but there is a lot of money in this area we have to spend. So we need to get an idea of how much we will be called upon to produce.

Nevertheless, Mr. Commissioner, I believe you are moving FHA in the right direction, as I told you earlier, and particularly HUD and FHA currently are proposing some significant changes to shore up the FHA single family mortgage insurance program by including an increase to annual premiums, as well as implementing a credit-related risk assessment. That assessment, as I understand it, would allow borrowers with a FICO score of 580 and above to make a 3.5 percent downpayment while home buyers with a FICO score of between 500 and 580 would be required to make a minimum downpayment of 10 percent. Borrowers with FICO scores below 500 would be ineligible for FHA mortgage insurance.

Some people are better off renting until they have the downpayment, and that is a point we have made before. We need to make sure rental housing is available so that people who cannot afford to buy a house do not get pushed into buying a house that they cannot afford. This has been a mistake that has been endemic in policymakers for the last 20 years in Washington. I will not cite the list of Members of Congress who pushed for it. I would say that it has been bipartisan at the administration level, and for 8 years, I fought the Bush administration pushing for the American dream no-downpayment home, which I characterized then, with some little guidance from the inspector general, as being a recipe for turning the American dream into the American nightmare.

But I think that the changes you are implementing, while they continue to promote home ownership, should lower the risk of financial exposure to the Federal taxpayer and the Federal Government. I know you have proposed a number of other reforms designed to protect the integrity of FHA and MMIF, including reforms to the appraisal process and a proposal to increase net worth requirements for FHA lenders.

These are controversial, but I am a firm believer that our financial system will be much stronger if people up and down the line; borrowers and securitizers and everybody else, has skin in the game. You look at Canada; they require a lot of skin in the game. They have a higher percentage of home ownership and much lower problems than we do because people there have to have skin in the game, which is the name of business.

Reforms are important but FHA still faces many challenges. I am concerned about the programs for default mitigation. We do not want to leave homeowners behind unless the financial criteria demand such an approach. If there is no way they can get out, we need to resolve it as humanely as possible and move on.

What role is HUD expecting to play over the next few years with regard to the administration's foreclosure mitigation policies and how will HUD reforms impact these policy efforts?

And while FHA seems to have been the administration's initial choice for implementing the administration and Congress' foreclosure mitigation strategies—congratulations on getting the ball on that one—much of the emphasis now seems to have shifted to Treasury and the GSEs, especially Fannie Mae with their GSE losses buried in TARP payments. It would be very helpful for us to understand Fannie and Freddie's new role in the mortgage crisis, especially since the GSEs recently reported fourth quarter losses, I believe, totaling $18 billion with an overall request of some $76 billion from Treasury's unlimited credit line. That is a number that should scare all of us. Last Monday, Fannie reported losses of another $8.4 billion. That is beginning to mount up to real money.

We cannot fool ourselves that these are just losses from an old book of business. Instead, Freddie was directed by the administration to buy back troubled loans from investors and obviously is taking losses on these mortgages. In fact, this policy appears to bail out lenders on their risky investment but it does little to save a home with a risky loan for a homeowner. And I am asking myself and others why. Why are we bailing out investors? That to me is a major concern.

As of last month, the opportunities to forestall housing foreclosures were virtually limited to wishful thinking where families could receive test funding for foreclosure mitigation but where the majority of these families would not qualify for mortgage reform and more permanent mortgage reform options.

Despite the administration's more optimistic view, without more options by the administration, families are destined to fall deeper in debt and be unable to meet the needed qualification for the mortgage reform permanent option. In other words, it is extremely unlikely that more than a scintilla of homeowners with looming mortgage foreclosures and high debts will qualify for the more permanent, long-term program.

That is bad news. The worse news is the longer we wait, the worse it will get. I think there are a number of other issues that have to be investigated somewhere, and I guess that we are about the only ones interested in it. There have been a number of articles that claim the affordable housing program under which Fannie and Freddie were required by law to invest in low-income housing helped to destabilize the GSEs. More troubling were Congressman Frank's efforts to tax Fannie's and Freddie's profits at more than $1 billion annually to benefit favored nonprofits and I would mention the infamous ACORN. These legislative requirements I think reinforce losses and undermine the financial credibility of the GSEs in the financial markets.

Most important, we need to know the administration's overall plan for revitalizing the housing industry and what will be the overall menu of tools for addressing the mortgage default crisis under FHA, the GSEs, Treasury, as well as other entities.

Finally, not everyone will be eligible for foreclosure mitigation relief, especially those without permanent employment or other income. Nevertheless, as we move forward, it is important that we all understand the contours of the various foreclosure mitigation programs and the potential exposure for additional financial losses in the housing marketplace both to the Federal Government as well as to other entities, families, and individuals.

I am very interested in how many homeowners we are likely to help and how many are likely to lose their homes. The answer is likely to be very troubling, as evidenced by a very negative report in March by the National Association of Homebuilders in its index which tracks home purchases.

FHA STAFFING SHORTFALLS

In addition, I am anxious to hear how FHA is addressing its staffing and expertise shortfalls as well as its plans to update fully the FHA IT systems. While there have been a number of comprehensive briefings with congressional staffs on these issues with FHA recently submitting a comprehensive staffing plan to Congress on its progress toward hiring an additional 118 FTEs for FHA-related activities, much remains to be done. The sooner we understand fully HUD's capacity and funding needs in these areas, the better we will able to respond through appropriations to the needs of HUD and FHA.

Finally, congratulations on your efforts on the mortgage and the mortgage insurance fraud. We cannot understate the fact that enforcement against mortgage fraud remains an area of overall weakness throughout the Nation, the mortgage market and likely FHA. I understand, however, FHA is making substantial progress with reforms in its mortgage programs, especially by eliminating the participation of bad lenders in the FHA program that should not be there.

In the predecessor to this subcommittee, the VA, HUD subcommittee, Senator Mikulski and I learned that these reforms are likely to be the tip of the iceberg, and now I would urge HUD and the HUD inspector general to continue to work with the Department of Justice and Treasury, along with other agencies, to develop a set of coordinated plans to put predatory lenders who are criminally at fault in prison. Seeing some of these people in orange jumpsuits may be one of the best remedial actions we can take.

Now not only does FHA require larger net worth requirements for all of its FHA lenders, it is also reviewing lender enforcement activities. In particular, as your written testimony indicates, since July 2009, FHA has referred some 365 cases of mortgage fraud or negligence to the Mortgagee Review Board. These investigations have resulted in the withdrawal of approval to underwrite FHA loans for some 354 lenders and the suspension of underwriting authority for another 6 lenders. It would be helpful to know what additional legislative authorities may be needed by HUD and the HUD inspector general to stop mortgage fraud and abuse around the Nation, including the laws that require jail sentences when some form of mortgage fraud is the subject of criminal action.

With that pessimistic statement, I look forward with optimism and enthusiasm to hearing your testimony, Commissioner Stevens.

Senator MURRAY. Thank you very much, Senator Bond.

Mr. Stevens, we will turn to you for your opening statement.

STATEMENT OF HON. DAVID H. STEVENS

Mr. STEVENS. Thank you, Chairwoman Murray and Ranking Member Bond. And thanks for the opportunity to be here to testify about the Federal Housing Administration's recent reforms, legislative proposals, contributions to the 2011 budget, and any other subjects that may be of interest.

I also do want to recognize, as you did, Senator, the involvement of the inspector general. He has been a very valuable advisor to me coming into this role with all the challenges we face, and we have had some great opportunities to partner. I share the zeal for enforcement on fraud and other issues, not just in the single family area, but the inspector general has been helpful in advice on multifamily issues and health care issues as well. So it is a critical partnership that I value very highly.

I appear before you at a moment when it is clear that the housing market has made significant progress toward stability. With the past year's record-low mortgage rates, thanks in large part to the administration's initiatives, more than 4 million homeowners have refinanced their mortgages to more affordable levels. This helped save homeowners more than $7 billion last year. More than 1 million families are saving an average of $500 per month through the administration's mortgage modification program, otherwise known as HAMP. Home equity has increased on average by more than $13,000 for homeowners in the last three quarters of 2009, and these efforts have begun to restore the confidence we need to get the economy moving, creating 290,000 jobs last month, the largest monthly increase in 4 years.

FHA

There is also encouraging news relating to foreclosures. Just this morning, RealityTrac released its latest monthly U.S. foreclosure report which shows foreclosure activity actually decreased 9 percent in the month of April. And FHA's second fiscal quarter numbers show our early delinquencies are better than expected. The number of loans in early default and claims has declined 15 percent since December, a strong indicator that the loan quality is improving.

The FHA has been essential to the improved outlook in the housing market. In the past 18 months, FHA protected 650,000 families from foreclosure, enabled more than 1.1 million homeowners to refinance into stable, affordable, fixed-rate mortgages, and insured 1.4 million new purchase loans, more than 80 percent of which were first-time home buyers. Indeed, as access to private capital has contracted in these difficult times, borrowers and lenders flocked to FHA, and the increased presence of FHA has help support liquidity in the purchase market, helping us ride through these difficult times until private capital returns.

During that time, Fannie and Freddie under conservatorship have also played an important role in stabilizing the market. The administration strongly supports the need for reform of the Government-sponsored enterprises and looks forward to working with Congress to enact meaningful reform in a manner that does not disrupt the Federal housing markets, nor increase the cost and reduce the availability of mortgages for American households. Toward this goal, we strongly support efforts to require thoughtful and thorough review, public commentary, and final study of reform options going forward.

While progress is clearly being made on many fronts, we continue to see challenges. The administration's strategies to address the housing crisis has evolved because our challenges have evolved. On March 26, we announced the FHA refinance option in conjunction with provisions to the HAMP modification program to tackle the challenge of underwater borrowers, one of the biggest threats to our continued recovery. The FHA refinance option will provide more opportunities for lenders to restructure loans for families who owe more than their home is worth due to price declines in their communities. These adjustments support principal reduction efforts already underway in the private market and offer incentives to expand their reach. The vast majority of the burden of writing down these loans will fall where it belongs, on lenders and investors, not the taxpayer. It is because FHA is in a stronger position today that we are able to facilitate these efforts to help more struggling homeowners.

With FHA's increased role, however, there is risk and responsibility. In addition to several policy changes that I have made since taking office on January—or we have made since January 20 of the year, we proposed several reforms to mitigate risk and replenish FHA's capital reserves. Some of these steps require legislative authority.

Thank you for the opportunity to explain these proposals in more detail in conjunction with the contributions to HUD's budget for the fiscal year 2011.

These policy changes have three guiding principles that we are balancing in all of them. First is how does it improve the capital reserves of FHA. Second, how does it impact the broader housing market and the recovery? And third, how does it impact FHA's role to provide opportunities for the underserved?

So first, we are asking Congress for authority to restructure FHA's mortgage insurance premiums. We would like to reduce the up-front premium to 100 basis points and increase the annual premium to 85 or 90 basis points, depending on the LTV. To more substantially increase FHA's reserves and facilitate the return of private capital to the mortgage market, these changes are needed.

We greatly appreciate the cooperation of Congress in support of these reforms, and on April 27, the House Financial Services Committee passed H.R. 5072, the FHA Reform Act, on a voice vote. The bipartisan authorizing bill would enable FHA to enact these proposed changes, which will further strengthen FHA's reserves and overall stability. And we look forward to working with this subcommittee and the Senate Banking Committee to enact similar legislation in the Senate as quickly as possible. If these changes are adopted during this current fiscal year, they would increase the value of the MMI Fund by approximately $300 million per month, which would replenish FHA's capital reserve even faster than if the authority was provided through the annual appropriations process.

Second, FHA is producing a two-step FICO floor for FHA purchases. Purchase borrowers with FICO scores of 580 and above would be required to make the minimum 3.5 percent downpayment. Those with FICO scores between 500 and 579 would be required to make a 10 percent downpayment. Anything below 500 would not be allowed.

Some have suggested that FHA raise the minimum requirement to 5 percent across-the-board as a way to improve loan performance. As you can see, we have gone further to 10 percent for low FICO scores to ensure that we are only insuring responsible loans. We determined, after extensive evaluation, that an across-the-board 5 percent proposal would be inadequate to control risk for some borrowers and excessive to control risk for responsible borrowers, which would adversely impact the housing market recovery. Increasing minimum downpayments to 5 percent across-the-board would translate to 300,000 fewer responsible first-time home buyers having access to home ownership and would have significant negative impacts to the broad housing market recovery. It would forestall the recovery of the housing market and potentially lead to a double dip in home prices by significantly curtailing demand. The policy changes that FHA has instead proposed in the 2011 budget would contribute an additional $4.1 billion in additional receipts to FHA and continue to support the broader housing market recovery.

The third policy change we are proposing is to reduce maximum seller concessions from its current 6 percent to 3 percent, which is in line with industry norms.

Our fourth proposal is to increase lender enforcement. In our 2009 fiscal year actuarial review, the independent actuary projected more than 71 percent of FHA's losses over the next 5 years will come from loans already on our existing books. That is why we have renewed our focus on enforcement and accountability, and since 2009, we have taken more action on more than six times the number of lenders than FHA had done in the past decade.

This year, we are requesting an appropriation of $250 million for FHA's reverse mortgage product. The HECM program provides seniors with a means to access their home equity to make ends meet and provide funds to pay for long-term health care and afford necessary home repairs and housing expense. We have conducted extensive analysis to identify the maximum policy changes we could perform to reduce risk to the taxpayer and maintain viability of the program. Without the budget request, we would be forced to reduce the amount of funds that would be available to seniors by more than 30 percent, which is an average of $23,000 to $27,000 in impact. Given the value of the program in assisting this critical population, HUD has requested an appropriation to maintain viability of the program for seniors while we are evaluating a broader range of program changes that may be necessary to ensure the success of HECM for the long term.

Finally, as you know, the CBO released its re-estimate of the 2011 budget, including the review of the FHA changes. Although the CBO estimate includes a significantly more conservative assessment of how these new changes made through the FHA's MMI Fund will perform in the coming years, both CBO and the administration forecast that with our proposed FHA changes, such credit activity will result in net receipts to the Government. We differ, however, on the amount. While the President's budget forecasts $5.8 billion in receipts, CBO re-estimated those net savings at $1.9 billion. In addition, CBO agreed with our forecast that Ginnie Mae and our GI SRI fund will result in roughly $1 billion more in net receipts.

While recognizing such a difference with CBO complicates budget resolution development, it is important to note that the $5.8 billion in receipts forecast in the President's budget will determine any receipts transferred to FHA's capital reserves. This will help the fund get back on track to be capitalized with the statutorily mandated 2 percent of insurance in force. I would also note that we remain confident in our forecast.

PREPARED STATEMENTS

I have submitted a more detailed testimony for the record, but Madam Chairwoman, as you can see, we have proposed a comprehensive set of reforms to improve loan performance, hold lenders accountable, and increase revenues to the FHA fund, while also ensuring that FHA continues to support the overall recovery of the housing market, continues to serve its mission of providing home ownership and financial opportunities for responsible borrowers and seniors. We look forward to working with Congress closely on all the issues and hope to gain your support for our budget proposal and legislative requests to further reduce the risk to the American taxpayer.

And with that, I am happy to answer questions.

[The statements follow:]

PREPARED STATEMENT OF HON. DAVID H. STEVENS

Chairwoman Murray, Ranking Member Bond, and members of the subcommittee, thank you for the opportunity to testify today regarding the Federal Housing Administration's (FHA's) recent reforms, legislative proposals, and contributions to the HUD fiscal year 2011 budget request. FHA remains focused on providing access to home ownership, while minimizing the risk to the American taxpayer is of the utmost importance.

HELPING PREVENT AN ECONOMIC CATASTROPHE

As you know, when this administration took office just over 15 months ago, the economy was hemorrhaging over 700,000 jobs each month, housing prices were in free fall, residential investment had dropped over 40 percent in just 18 months, and credit was frozen nearly solid. Many respected economic observers warned that a second Great Depression was a real possibility, sparked of course by a crisis in the housing market. Meanwhile, communities across the country—from central cities to newly built suburbs to small town rural America—struggled to cope with neighborhoods devastated by foreclosure, even as their soaring jobless rates and eroding tax base crippled their ability to respond.

As we move beyond the peak of the recent global financial crisis, though there is still a long way to go, it is clear that the Nation's housing market has made significant progress toward stability. Through the combination of coordinated efforts by Treasury, HUD, and the Federal Reserve to stabilize the housing market, we are seeing real signs of optimism.

As measured by the widely referenced FHFA index, home prices have significantly stabilized since last April. As recently as January 2009 house prices had been projected to decline by as much as 5 percent in 2009 by leading major macro-economic forecasters. This housing stabilization is all the more surprising since most forecasters had underestimated the rise in unemployment that has occurred over the past year.

Homeowner equity started to grow again—increasing by over $1 trillion by the end of December, or $13,000 on average for the Nation's nearly 75 million homeowners, and helping our economy grow at the fastest rate in 6 years in the fourth quarter of last year.

And mortgage rates which have been at or near historic lows for more than a year have spurred a refinancing boom that has helped nearly 4 million borrowers in 2009—freeing up an additional $7 billion annually, some of which will be spent in local economies and businesses, generating additional revenues for our Nation's cities, suburbs, and rural communities.

FHA—FACILITATING RECOVERY

While there remains uncertainty about whether this progress will continue at this pace going forward, what is not in doubt is that the FHA has been central to much of this improvement.

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

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

We know the critical role first-time home buyers are playing in the market, including purchasing REO and vacant properties, helping stabilize home prices and communities alike. More than three-quarters of FHA's purchase-loan borrowers in 2009 were first-time home buyers, and nearly one-half of all first-time buyers in the housing market in the second half of last year used FHA loans.

FHA provides mortgage insurance to help lenders reduce their exposure to risk of default. This assistance allows lenders to make capital available to many borrowers who would otherwise have no access to the safe, affordable financing needed to purchase a home.

As access to private capital has contracted in these difficult economic times, borrowers and lenders have flocked to FHA and the ready access it provides to the secondary market through securitization by Ginnie Mae. The increased presence of FHA and others in the housing market, including Fannie Mae and Freddie Mac, has helped support liquidity in the purchase market, helping us ride through these difficult times until private capital returns to its natural levels.

And with 51 percent of African Americans home buyers and 45 percent of Hispanic families who purchased homes in 2008 [1] using FHA financing, FHA is far and away the leader in helping minorities purchase homes.

FHA has stepped up to fulfill its countercyclical role—to temporarily provide necessary liquidity while also working to bring private capital back to credit markets. Indeed, the FHA has in the past year alone helped more than 800,000 homeowners refinance into stable, affordable fixed-rate mortgages.

At the same time FHA has taken steps to reverse falling home prices, it has also worked to help families keep their homes, deploying its loss mitigation tools to assist a half million families at risk of foreclosure.

Not only is FHA ensuring the availability of financing for responsible first time home purchasers, it is also helping elderly homeowners borrow money against the equity of their homes through the Home Equity Conversion Mortgage (HECM). This

[1] Federal Financial Institutions Examination Council (FFIEC) 2008 Home Mortgage Disclosure Act (HMDA) data. Published on December 23, 2009, this is the most recent data available.

program has grown steadily in recent years, to a volume of $30.2 billion in fiscal year 2009.

And finally, FHA is playing an important role in protecting homeowners and helping prospective homeowners make informed decisions. It is providing counseling to homeowners to help them avoid falling into unsustainable loans. And it is fighting mortgage fraud vigorously on all fronts, having taken enforcement actions on more than six times as many lenders since fiscal year 2009 than those over the fiscal year 2000–2008 period combined.

The central role of housing in the U.S. economy demands that Federal agencies involved in housing policymaking rethink and restructure programs and policies to support housing as a stable component of the economy, and not as a vehicle for overexuberant and risky investing.

With that in mind, the President's budget for 2011 represents a careful, calibrated balancing of FHA's three key responsibilities: (1) providing home ownership opportunities to responsible borrowers, (2) supporting the housing market during difficult economic times and (3) ensuring the health of the FHA Mutual Mortgage Insurance (MMI) fund.

With this budget, HUD is projecting that FHA will continue to play a prominent role in the mortgage market in fiscal year 2011. Accordingly, it requests a combined mortgage insurance commitment limitation of $420 billion in fiscal year 2011 for new FHA loan commitments for the Mutual Mortgage Insurance (MMI) and General and Special Risk Insurance (GI/SRI) funds. The proposed total includes $400 billion under the MMI Fund, which supports insurance of single family forward home mortgages and reverse mortgages under HECM; and $20 billion under the GI/SRI Fund, which supports multifamily rental and an assortment of special purpose insurance programs for hospitals, nursing homes, and title I lending. The budget requests a direct loan limitation of $50 million for the MMI fund and $20 million for the GI/SRI fund to facilitate the sale of HUD-owned properties acquired through insurance claims to or for use by low- and moderate-income families.

The budget also includes $88 million for the Housing Counseling Assistance program, which is the only dedicated source of Federal funding for the full spectrum of housing counseling services. With these funds we also plan to continue our work to expand the number of languages in which counseling is available. In addition, the budget continues FHA's Mortgage Fraud initiative ($20 million) launched in fiscal year 2010 as well as implementation of sweeping reforms to the Real Estate Settlement and Procedures Act (RESPA) which began in January 2010 and the Secure and Fair Enforcement (SAFE) for Mortgage Licensing Act beginning in June 2010.

REBUILDING FHA'S CAPITAL RESERVES

As important as FHA is at this moment to our Nation's economy, FHA has not been immune to the hard times for the housing sector. Late last year, we reported to Congress that FHA's secondary reserves had fallen below the required 2 percent level—to 0.53 percent of the total insurance-in-force. However, when combined with reserves held in the Financing Account, FHA reported with its fiscal year 2009 actuarial review that it holds more than 4.5 percent of total insurance-in-force in reserves—$31 billion set aside specifically to cover losses over the next 30 years.

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

Further, while its Capital Reserve Account has decreased too quickly, FHA is not "the next subprime" as some have suggested.

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

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

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

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

REFORMS TO DATE

From my first day as FHA Commissioner, I began a thorough review of our loan practices and organizational capacity and gaps. We have already taken several steps within our existing authority to shore up the FHA and continue to improve our operations to ensure that taxpayers are not put at risk.

In addition to steeply increasing lender enforcement, we've strengthened credit and risk controls—toughening requirements on our Streamlined Refinance program, made several improvements to the appraisal process, and published a final rule in the Federal Register on April 20 to increase net worth requirements for all FHA lenders.

Long overdue, FHA hired its first Chief Risk Officer, Robert Ryan, to provide the most comprehensive and thorough risk assessment in the organization's history—and ensure that the assumptions going into our modeling reflect the most current economic conditions.

In addition, with Congress' help, we are working to increase staffing and technical capacity and upgrade our technology systems—and though we still have a long way to go, we delivered FHA's first comprehensive technology transformation plan to Congress in September. We have continued to make progress on both fronts. We recently issued and received several responses to a Request for Information to begin upgrading our risk and fraud tools and we delivered a FHA Staffing Report to Congress, which outlines our significant progress toward hiring the 118 FTEs that we thank Congress for appropriating to FHA in fiscal year 2010, along with details on an aggressive training and human capital development plan that includes managerial and technical skill building training as well as on-the-job mentoring.

Lender Enforcement

Under the Obama administration, FHA has significantly increased its lender enforcement activities to protect the MMI Fund, consumers, and address a number of bad actors that were previously not held accountable.

Since July 1, 2009, the Mortgagee Review Board (MRB) has investigated 365 cases, resulting in withdrawal of approval for 354 lenders and suspension of an additional 6 lenders. The number of cases that have been investigated by the MRB since July 2009 are greater than those investigated in the years 2002–2008 combined.[2] We take our responsibility to oversee lenders with the utmost seriousness. I would also like to emphasize that FHA's intent is to protect the Fund through a commitment to lender enforcement, but FHA in no way intends to punish responsible lenders. We are working closely with lenders to identify best practices and share them among the lending community, proactively identify problem situations and identify means to improve performance, to the benefit of lenders, consumers, and the FHA.

JANUARY POLICY ANNOUNCEMENTS AND LEGISLATIVE REQUESTS

On January 20 of this year, I proposed taking the following steps to mitigate risk and augment the MMI Fund's capital reserves: increase the mortgage insurance premium (MIP); impose a firm floor on allowable credit scores, and further tighten the minimum credit score required for borrowers with low down payments; reduce the maximum permissible seller concession to match the industry norm; and implement a series of significant measures aimed at increasing lender responsibility and enforcement. Thank you for the opportunity to explain these policies in more detail.

I would like to be clear that many of these reforms were long overdue as FHA did not respond effectively to changes in the marketplace that happened during the housing boom and the subsequent decline—inaction was and is not an option. In addition to the Congressional mandate to take action to bring FHA's capital reserves back up above 2 percent, FHA also has a responsibility to protect consumers from irresponsible lending practices, protect the taxpayer from excessive claims on the MMI fund, and facilitate the return of private capital to the mortgage market. We take these responsibilities seriously, as evidenced by the series of policies that we have already enacted and those that we request Congressional authority to enact.

FHA conducted an exhaustive review of loan performance in its portfolio and a thorough policy development process to ensure that these policy changes balance three guiding principles: (1) improve FHA loan performance and capital reserves, (2) continue to support the broader housing market and recovery, and (3) preserve

[2] See Appendix for Historical Data on Mortgagee Review Board Actions.

FHA's role in providing home ownership opportunities to responsible underserved borrowers. Each one of our policy changes fulfills these three priorities. Additionally, FHA evaluated several dozen other policy options which ultimately were not chosen as they did not strike the appropriate balance. With these factors, in mind, FHA has proposed a series of balanced policy proposals that fulfill our responsibility to the American taxpayer and recognizes the important role that FHA is currently playing in the recovery of the housing market.

Restructuring FHA Mortgage Insurance Premiums

First, insurance revenues from single family loan guarantees will grow by increasing the upfront premium to 225 basis points across all FHA forward product types (purchase, conventional to FHA refinances, and FHA to FHA refinances). The upfront premium increase was implemented by mortgagee letter issued on January 21, 2010 and became fully effective in the market for all applications received on or after April 5, 2010. I would like to thank Congress for providing FHA with the flexibility to increase the upfront premium to a maximum of 300 basis points through passage of the Housing and Economic Recovery Act (HERA) in 2008. While we have not chosen to increase the upfront premium to the maximum, this flexibility has enabled FHA to take immediate action to begin rebuilding our capital reserves. Similarly, we request flexibility in our legislative proposal to increase the annual premium to 150 basis points although we have not proposed to increase the annual premium to that level in our fiscal year 2011 budget proposal.

As noted in the proposed budget, while HUD is moving to increase the upfront premium to 225 basis points we are ultimately planning to reduce that premium to 100 basis points, offset by a proposed increase in the annual premium to 85 basis points for loans with loan-to-value ratios (LTV) up to and including 95 percent and to 90 basis points for LTVs above 95 percent.

This change to the annual premium will require legislative authority. We are extremely grateful that the House Financial Services Committee recently passed H.R. 5072—the FHA Reform Act of 2010—which provides this authority as well as several other provisions to further strengthen FHA. This legislation is now awaiting passage by the full House of Representatives. Given the importance of these issues to FHA's ability to facilitate our housing recovery while protecting the taxpayer, we hope that the Senate will similarly move to pass this legislation as expeditiously as possible.

We believe this new premium structure is sound policy—more in line with GSE and private mortgage insurers' pricing, and is intended to facilitate the return of private capital to the mortgage market.[3] Indeed, if these changes are adopted during the current fiscal year, the estimated value to the MMI fund would be approximately $300 million per month, which would replenish FHA's capital reserves even faster than if this authority was provided through the annual appropriations process.

This restructuring of FHA's mortgage insurance premiums will accomplish two very important goals: (1) increase the homeowner's equity in each mortgage transaction and reduce the risk to the FHA fund; and (2) facilitate the return of private capital to the mortgage market.

Increasing Equity in FHA Loans

As stated earlier, if granted legislative authority to increase the annual mortgage insurance premium, FHA proposes to reduce the upfront mortgage insurance premium from 225 basis points to 100 basis points. Borrowers typically finance the upfront mortgage insurance premium in their loan balance, increasing the effective loan-to-value and reducing the amount of equity in their home. The reduction of the upfront premium will lower the loan balance as well as add an additional 125 basis points of equity to each loan purchase.

Facilitating the Return of Private Capital to the Mortgage Market

As noted, the elevated role FHA is currently playing in the market is temporary. In addition to being more equitable for borrowers and generating more receipts for FHA, this change to the FHA premium structure brings FHA's pricing more in-line with the private mortgage insurance industry and enables more robust private competition. In fact, in response to FHA's announced policy changes, MGIC, the largest U.S. private mortgage insurer, announced on February 23 that it would be adopting a new pricing scale.[4]

[3] See Appendix for detailed information about the effect of proposed premium rate changes on home buyers.

[4] "MGIC Lowers Rates to Compete With U.S.-Backed Mortgage Insurers," Bloomberg, February 23, 2010.

Updating Credit Score/Downpayment Guidelines

FHA is also proposing a "two-step" FICO floor for FHA purchase borrowers, which would reduce both the claim rate on new insurance as well as the loss rate experienced on those claims. Purchase borrowers with FICO scores of 580 and above would be required to make a minimum 3.5 percent down payment; and those with FICO scores between 500–579 would be required to make a minimum down payment of 10 percent. Applicants below 500 would be ineligible for insurance. FHA plans to publish the two-step FICO proposal in the Federal Register soon, with implementation planned later this fiscal year.

Careful analysis of the existing FHA loan portfolio shows a clear performance difference between loans that were made below the proposed FICO/LTV guidelines. Loans below the guidelines are currently more than four times as likely to be seriously delinquent than loans above the guidelines. Loans below the guidelines demonstrate a seriously delinquent rate of 31.1 percent, while loans above the guidelines currently demonstrate a seriously delinquent rate of 7.6 percent. Of the total FHA loan portfolio, approximately 6 percent of loans fall under the proposed guidelines; however, due to improved quality of recent FHA loans, only 1.5 percent of loans endorsed in fiscal year 2009 would be excluded under the proposed guidelines.

LOAN PERFORMANCE BASED ON PROPOSED UPDATED CREDIT SCORE/DOWNPAYMENT GUIDELINES

[In percent]

Proposed Two Step Rule	Outstanding Loans	30-Day	60-Day	90-Day	In Foreclosure	In Bankruptcy	Seriously Delinquent (90-Day+)
Excluded	6.2	12.1	6.7	19.9	8.1	3.0	31.1
Still Qualify	93.8	5.0	2.1	4.9	2.0	0.7	7.6
Total	100.0	5.5	2.4	5.9	2.4	0.8	9.1

Source: U.S. Department of HUD/FHA; February 2010.

If implemented, in combination with the proposed mortgage insurance premium structure, the updated FICO/LTV guidelines are projected to result in the $4.1 billion in additional offsetting FHA receipts as reflected in the President's budget.

Minimum Downpayment for FHA Loans

Some have suggested that FHA raise the minimum required downpayment to 5 percent across the board and also remove the option of financing the upfront insurance premium into the loan balance for all transactions as a means to increase homeowner equity. We share the goal of increasing equity in home purchase transactions, but determined after extensive evaluation that such a proposal would adversely impact the housing market recovery.

To determine the impact of requiring a minimum 5 percent downpayment for all transactions, FHA evaluated the loan files of a large sample of past endorsements to identify the number of borrowers who had sufficient assets at time of loan application to contribute the additional 1.5 percent of equity at closing. As illustrated in the table below, such a policy change would reduce the volume of loans endorsed by FHA by more than 40 percent, while only contributing $500 million in additional budget receipts. This translates to more than 300,000 fewer first-time home buyers and would have significant negative impacts on the broader housing market—potentially forestalling the recovery of the housing market and potentially leading to a double-dip in housing prices by significantly curtailing demand. In contrast, the combination of policy changes proposed by FHA in the fiscal year 2011 budget would contribute an additional $4.1 billion in additional receipts to FHA while having a much more moderate impact on the broader housing market.

IMPACT OF FISCAL YEAR 2011 POLICY OPTIONS ON FHA RECEIPTS AND LOAN VOLUME

[In billions of dollars]

Policy Option	FHA Receipts	FHA Loan Endorsements
Baseline without policy changes	1.7	246
Minimum 5 percent downpayment for all transactions	2.2	139
Fiscal Year 2011 Budget Proposal with all proposed policy changes	5.8	223

Source: U.S. Department of HUD/FHA; February 2010.

Furthermore, downpayment alone is not the only factor that influences loan performance. The combination of downpayment and FICO score is a much better predictor of loan performance than just one of those components alone. For instance, loans with a loan-to-value (LTV) above 95 percent and a FICO score above 580 perform better than loans with LTV below 95 percent and a FICO score below 580, while loans with a LTV above 95 percent and a FICO score below 580 perform significantly worse than all other groups, as illustrated below.

FHA SINGLE FAMILY INSURED LOAN CLAIM RATES RELATIVE EXPERIENCE BY LOAN-TO-VALUE AND CREDIT SCORE VALUES [1]

[Ratios of each Combination's Claim Rate to that of the Lowest Risk Cell [2]]

Loan-to-Value Ratio Ranges	Credit Score Ranges [3]			
	500–579	580–619	620–679	680–850
Up to 90 percent	2.6	2.5	1.9	1.0
90.1–95 percent	5.9	4.7	3.8	1.7
Above 95 percent	8.2	5.6	3.5	1.5

[1] Based on experience of the fiscal year 2005–fiscal year 2008 insurance cohorts, as of February 28, 2010. These ratios represent averages of the cell-level ratios in each cohort.

[2] Claim rates in the first row and last column are the low-risk cell and are represented by a ratio value of 1.00. Values in all other cells of this table are ratios of the cell-level claim rate to the claim rate of the low-risk group.

[3] Loan-level scores represent the decision FICO scores used for loan underwriting. This analysis includes all fully-underwritten loans, purchase and refinance, but excludes streamline refinance loans.

Source: U.S. Department of HUD/FHA; March 2010.

It is for these reasons, rooted in a thorough review of actual FHA loan performance data, that FHA has decided to reduce the upfront mortgage insurance premium, which is financed into the loan balance in the vast majority of transactions, and increase the annual mortgage insurance premium, which is paid over time and not financed into the loan balance, which is more aligned with the premium structure of private mortgage insurance companies.

In particular, we have proposed to permit loans to borrowers with FICO scores above 580 with a minimum 3.5 percent downpayment and loans to borrowers with FICO scores between 500 to 579 with a minimum 10 percent downpayment. It is also worth noting that these downpayment guidelines are minimums and many borrowers do in fact have significantly lower LTVs—in the fourth quarter of fiscal year 2009, more than 21 percent of endorsed loans had a LTV lower than 90 percent.

Reducing Seller Concessions

We are also proposing a third policy measure to reduce the maximum permissible seller concession from its current 6 percent level to 3 percent, which is in line with industry norms. The current level exposes the FHA to excess risk by creating incentives to inflate appraised value. As seen in the table below, FHA's experience shows that loans with high levels of seller concessions are significantly more likely to go to claim. Experience to-date on loans insured from fiscal year 2003 to fiscal year 2008 suggests that claim rates on high-concession loans are 50 percent higher or more than those on low-concession loans.

FHA SINGLE-FAMILY INSURANCE TO-DATE CLAIM RATE COMPARISON LOW (0–3 PERCENT) VS. HIGH (3.1–6 PERCENT) SELLER CONCESSIONS [1]

[As of December 31, 2009]

Endorsement Fiscal Year	Low Concessions (percent)	High Concessions (percent)	Ratio High/low
2003	6.5	10.7	1.65
2004	6.6	11.6	1.76
2005	7.2	11.2	1.54
2006	6.5	9.5	1.46
2007	4.6	6.3	1.36
2008	1.0	1.5	1.60

[1] As a percentage of the home price. This analysis is only for home purchase loans.

Source: US Department of Housing and Urban Development, Federal Housing Administration; January 2010.

Increasing Lender Enforcement

In its fiscal year 2009 Actuarial Review, the independent actuary projected that more than 71 percent of FHA's losses over the next 5 years will come from loans already on our existing books, rather than from newly insured loans. That's why an important step we can take to minimize losses to capital reserves in the near term is to step up enforcement and make lenders more accountable. As mentioned earlier, we have renewed our focus on enforcement and lender accountability.

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 the error may have impacted the original loan decision, or in which fraud or misrepresentation were involved. FHA currently has this authority for loans originated through the Lender Insured (LI) process, which accounts for 70 percent of FHA loan volume, but only 29 percent of FHA-approved lenders. FHA is asking that Congress grant explicit authority to require indemnification for loans that were improperly originated for the remaining 71 percent of FHA-approved lenders. FHA is simply requesting that Congress permit FHA to hold all lenders to the same standard; FHA is not asking for expansion of authorities beyond those already granted to FHA to oversee lenders participating in the LI program.

As you can see, we have proposed a comprehensive set of reforms to improve loan performance, hold lenders accountable, and increase revenues to the FHA fund, while also ensuring that FHA continues to support the overall recovery of the housing market and continue to serve its mission of providing home ownership opportunities for responsible borrowers. We look forward to working with Congress closely on all these issues and hope to gain your support for our legislative requests to further reduce risks to the American taxpayer.

CBO SCORING

On March 5, the Congressional Budget Office released its re-estimate of the President's 2011 budget. Although the CBO re-estimate includes a significantly more conservative assessment of how new loans made through FHA's MMI Fund will perform in coming years, both CBO and the administration forecast that such credit activity will result in net receipts to the Government. We differ, however, on the amount. While the President's budget forecast $5.8 billion in net receipts resulting primarily from insurance premia and other fees assessed on FHA loans, CBO re-estimated those receipts at $1.9 billion. Accordingly, CBO's scoring suggests our policies will cost $3.9 billion more than we estimated in our submission to you.

While recognizing that such a difference with CBO complicates budget resolution development, we remain confident that the $5.8 billion in receipts forecast in the President's budget will be realized and transferred to FHA's Capital Reserve Account. This will help that fund get back on track to be capitalized with the statutorily mandated 2 percent of insurance in force.

HOME EQUITY CONVERSION MORTGAGE (HECM)

This year, we are requesting an appropriation of $250 million to support FHA's reverse mortgage product—the Home Equity Conversion Mortgage, or HECM, program. The HECM program provides seniors with a means to access their home equity to make ends meet. A survey conducted by AARP in 2006 showed that the product provided seniors with much-needed financial relief and was primarily used to pay for long term healthcare, enable home repairs, and provide piece of mind that housing expenses could be met.[5] Another study, conducted by the National Council on Aging in 2005 showed how the program can help seniors access in-home healthcare services, an arrangement that allows households to "age in place" rather than undergoing disruptive transitions into nursing homes or other types of public facilities to receive health-related assistance. Keeping seniors in their homes and communities, close to familiar support networks, puts less pressure on our Nation's overextended nursing home infrastructure and the public resources that support it.

We have performed considerable analysis to perform the maximum policy changes that we could perform to reduce risk to the taxpayer and maintain the viability of the program, which is why we have proposed for fiscal year 2011 an increase in the annual mortgage insurance premium from 0.50 percent to 1.25 percent and a further reduction in the principal limit factors (PLFs) of approximately 1 to 5 percent depending on the age of the borrower, on top of the 10 percent reduction in PLFs that was implemented at the beginning of fiscal year 2010.

Without the budget request, we would be forced to reduce the PLFs by an additional 21 percent in fiscal year 2011. This would significantly reduce the amount of funds that would be available to seniors (more than 30 percent), which is on average a $23,000 to $27,000 impact.

Any additional steep cut to the PLFs will result in serious decline in program level as HECMs would no longer be viable to many seniors who need to access their home equity while staying in their homes. It is important to note that the need for this type of program is greater now than it's ever been, due to increasing medical costs, declining employment/incomes, and less "savings" in various types of pension funds/retirement accounts.

Forecasts suggest that future house prices will grow more slowly than in the past, and the HECM program costs are very sensitive to future house prices. As such, we have also assembled a working group with the Department to see what other kinds of broader program changes could be made going forward to make the program more viable even under stressful economic times.

Given the value of this program in assisting this critical population, HUD has requested an appropriation to maintain the viability of this option for seniors while we evaluate the range of broader program changes that may be necessary to ensure the success of the HECM program into the future.

HUD'S CENTRAL ROLE IN PREVENTING FORECLOSURES AND STABILIZING NEIGHBORHOODS

On March 26, as part of the administration's continued efforts to assist homeowners to avoid foreclosure, HUD announced adjustments to the FHA program, referred to as the FHA refinance option, that will allow lenders to provide additional refinancing options to those borrowers who owe more on their home than it is worth if combined with a principal write down by their lender or mortgage investor. These adjustments will provide more opportunities for qualifying mortgage loans to be responsibly restructured and refinanced into FHA loans as long as the borrower is current on the mortgage and the lender reduces the amount owed on the original loan by at least 10 percent. We have also expanded the FHA loan modification program, known as FHA HAMP, to provide incentives for servicers to modify loans in-

[5] "Reverse Mortgages: Niche Product or Mainstream Solution? Report on the 2006 AARP National Survey of Reverse Mortgage Shoppers," AARP Public Policy Institute Paper #2007–22. and "Use Your Home to Stay at Home," National Coalition on the Aging, 2005. http://www.ncoa.org/news-ncoa-publications/publications/reversemortgagereportpublications.pdf.

sured by the FHA. With the issuance of new rules on March 26 (Supplemental Directive 10–03), TARP-funded incentives will be available to borrowers and servicers whose loans are modified under the FHA–HAMP guidelines, corresponding to the pay-for-success HAMP incentive structure. In addition to efforts to improve the execution of the administration's Making Home Affordable program, HUD is utilizing long-existing mechanisms as well as additional authority provided in recently enacted legislation to aid distressed homeowners and to address community blight resulting from foreclosed and abandoned properties.

FHA Refinance Option.—To address the challenge of underwater homeowners, we have made adjustments to Federal Housing Administration (FHA) programs that will permit lenders to provide additional refinancing options to homeowners who owe more than their home is worth because of large falls in home prices in their local markets. These adjustments will provide more opportunities for qualifying mortgage loans to be responsibly restructured and refinanced into FHA loans as long as the borrower is current on the mortgage and the lender reduces the amount owed on the original loan by at least 10 percent. This option will be made available in the market in early fall.

The new FHA loan must have a balance less than the current value of the home, and total mortgage debt for the borrower after the refinancing, including both first and any other mortgages, cannot be greater than 115 percent of the current value of the home—giving homeowners a path to regain equity in their homes and an affordable monthly payment. By requiring a meaningful principal write-down in conjunction with the newly refinanced loan, borrowers will have a more sustainable loan that will be more affordable. Additionally, borrowers will have an opportunity to refinance into current interest rates, which remain low.

The new loan must conform to FHA's underwriting requirements, so performance would likely fall within acceptable risk thresholds for FHA. That being said, there is reasonable concern that there may be a performance differential—these loans may perform worse than refinanced loans that were not previously underwater. As such, loans that conform to all guidelines of the FHA refinance option will be counted separately toward lender performance monitoring through Credit Watch—the system by which FHA suspends or terminates lenders for high default rates. Originating these loans will not hinder a servicer's ability to pursue other lines of business, mitigating a potential barrier to servicers' and investors' willingness to offer principal writedowns to borrowers.

Of the $14 billion of TARP funds allocated to support the FHA refinance option, a portion will be made available to provide coverage for a share of potential losses on these loans, mitigating detrimental impacts to FHA's capital reserve from facilitating the private sector to provide principal writedowns to underwater borrowers in conjunction with these refinancings. No TARP funds will go to the FHA itself for any loans.

This refinancing will help homeowners by setting monthly payments at affordable levels and decreasing the mortgage burden for families owing significantly more than their homes are worth. Keeping more responsible families in their homes should support the continued recovery of the housing market.

Established FHA Loss Mitigation Efforts.[6]—Homeowners of FHA-insured loans have long been eligible for a variety of loss mitigation programs to help protect them from foreclosure. In 2009, more than 450,000 families were assisted through a variety of methods, including forbearance, partial claim, loan modification, pre-foreclosure sale, and deed-in-lieu of foreclosure. In the first quarter of fiscal year 2010, FHA assisted more than 122,000 through these programs. Servicers of FHA-insured loans are required to notify delinquent homeowners about the option(s) that are available to help them make their monthly payments and to implement loss mitigation efforts before they take the final step of initiating foreclosure proceedings.

FHA-Home Affordable Modification Program (FHA–HAMP).—When initially introduced to the public, the Making Home Affordable program excluded FHA-insured mortgages and stated that FHA would develop its own stand alone program. On July 30, HUD announced final rules implementing the FHA's program—the FHA Home-Affordable Modification Program (FHA–HAMP)—which is an important complement to MHA and provides homeowners in default (or at-risk of imminent default) with greater opportunity to reduce their mortgage payments to a sustainable level. All servicers were expected to begin offering FHA–HAMP by August 15. This new loss mitigation program was authorized under the "Helping Families Save Their Homes Act of 2009," signed into law on May 20, and allows FHA to give qualified FHA-insured borrowers the opportunity to obtain assistance under terms roughly comparable to borrowers in other segments of the market, without increasing

[6] See appendix for description of FHA's loss mitigation programs.

costs to the taxpayer. This program allows HUD to permanently reduce a family's monthly mortgage payment to an affordable level by offering a partial claim of up to 30 percent of the unpaid principal balance. This defers the repayment of the mortgage principal reduction through an interest-free subordinate mortgage that is not due until the first mortgage is paid off.

At the initiation of FHA HAMP in August 2009, it was projected to provide assistance to over 45,000 households over the next 3 years. As of January 31, 2010, lenders have sent over 15,000 trial plans and over 10,000 borrowers have made at least 1 payment on their trial plan. FHA–HAMP loan volume is currently above projections for the 3 year milestone and all but one major lender has borrowers under a trial program.

Pay for success payments were included for borrowers and servicers that utilized the conventional HAMP. However, at the time of its announcement, FHA–HAMP did not include Pay for Success payments for servicers or mortgagors that made on time payments as it required regulatory action to be eligible for FHA-insured mortgages. We have worked diligently to complete this process and FHA issued a mortgagee letter that enables FHA–HAMP borrowers and servicers to be eligible for Pay for Success payments. Consequently, it is expected that demand for FHA–HAMP will increase.

Assistance for Borrowers Facing Imminent Default.—On January 22, 2010, FHA announced that it was exercising authority granted to it by Congress through the Helping Families Save Their Home Act of 2009 to use its loss mitigation tools to assist FHA borrowers avoid foreclosure to include those facing "imminent default" as defined by the Secretary. Homeowners with FHA-insured mortgage loans who are experiencing financial hardship are now eligible for loss mitigation assistance before they fall behind on their mortgage payments. Previously, these homeowners were not eligible for such assistance until after they had missed payments. Now servicers will have additional options for those borrowers who seek help before they go delinquent, which increases the likelihood that the borrower will be able to retain their home.

The borrower must be able to document the cause of the imminent default which may include, but is not limited to, one or more of the following types of hardship:

—A reduction in or loss of income that was supporting the mortgage loan, e.g., unemployment, reduced job hours, reduced pay, or a decline in self-employed business earnings. A scheduled temporary shutdown of the employer, (such as for a scheduled vacation), would not in and by itself be adequate to support an imminent default.

—A change in household financial circumstances, e.g., death in family, serious or chronic illness, permanent or short-term disability

Improving Servicer Outreach and Performance in Preventing Foreclosures.—FHA is working closely with lenders and servicers to improve their outreach and performance in assisting borrowers to avoid foreclosure. In February 2010, FHA's Office of Single Family Asset Management and the FHA National Servicing Center began conducting lender visits to identify best practices that could be shared with the broader servicing community to improve foreclosure mitigation across the industry. The visits were conducted with five overall objectives: (1) better understand in specific detail the process variations that exist at each lender for providing a delinquent FHA borrower with options to avoid foreclosure; (2) discuss specific borrower trends the lenders are experiencing; (3) identify borrower circumstances that prevent them from being qualified for various foreclosure prevention options; (4) receive suggestions from the lender that might improve the process for FHA loss mitigation; and, (5) understand the differences in default/foreclosure statistics as compared to national averages. Several findings have already been identified and FHA has begun to share them with servicers, while continuing to meet with additional lenders to identify additional best practices that will enable underperforming servicers to improve their success with preventing foreclosures. It is worth noting that these best practices are not limited to the FHA population, and HUD's efforts in this area will benefit all homeowners, not only those with a FHA-insured mortgage, by collaborating with the servicer community to improve their foreclosure prevention activities across the entire industry.

Counseling.—HUD is utilizing its vast network of counselors and other nonprofits to provide critical assistance to the record number of homeowners at-risk of foreclosure. It is estimated that more than one-half of all foreclosures occur without servicers and borrowers ever engaging in a discussion about potential options to prevent foreclosure. That is why we have directed HUD-approved counselors to educate homeowners about their various options, promote the MHA program in local communities, and assist distressed homeowners with navigating the system so they can reach servicers and obtain assistance to avoid foreclosure.

HUD-approved counselors are located across the Nation and provide distressed homeowners with a wealth of information. The counselors provide assistance over the phone and in person to individuals seeking help with understanding the Making Home Affordable program, explain options available to FHA-insured homeowners, and often work with borrowers eligible for the administration's refinance or modification program to compile an intake package for servicers. These services are provided free of charge by nonprofit housing counseling agencies working in partnership with the Federal Government and funded in part by HUD and NeighborWorks® America. In addition, HUD, working with Treasury and the Homeownership Preservation Foundation, encourages distressed borrowers to contact the Homeowner's HOPE Hotline at 866–995–HOPE to receive counseling and advice on avoiding foreclosures. The 24 hours a day, 7 days a week hotline utilizes many HUD-approved counselors who can also help the homeowner reach and resolve issues with servicers.

Neighborhood Stabilization Program (NSP).—HUD recognizes that concentrated foreclosures can wreak havoc on once-stable communities and is working to insure that the nearly $6 billion appropriated by Congress for NSP plays the intended role of helping to stabilize housing markets and combat blight through the purchase and redevelopment of foreclosed and abandoned homes and residential properties. NSP is starting to generate real results and is emerging as a vital resource in facilitating the transformation of foreclosed homes into affordable housing and other useful properties. HUD continues to monitor program activities, identify strategies that produce real results, and work to make program modifications that will help ensure that this funding is deployed quickly, wisely, and effectively. Additionally, FHA and HUD's Office of Community Planning and Development have created a working group to assist NSP grantees to better coordinate the use of NSP funds for the purchase of FHA REO properties.

FACILITATING OUR RECOVERY, BUT PROTECTING THE TAXPAYER

Madam Chairwoman and Ranking Member Bond, shoring up the FHA won't solve all our housing challenges—one reason the administration is working to produce a more balanced, comprehensive national housing policy that supports home ownership and rental housing alike, providing people with the options they need to make good choices for their families.

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

That means that while we must remain mindful that qualified, responsible families need the continued ability to purchase a home, the changes and legislative requests that we have announced are crafted to ensure FHA steps back to facilitate the return of the private sector as soon as possible. Until the private sector can step back up, they need the FHA—and so does our housing market.

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

APPENDIX.—MORTGAGEE REVIEW BOARD HISTORICAL ACTIONS BY FISCAL YEAR

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total Number of Cases	61	92	14	63	47	38	21	18	95	593	360
Fact Based Cases	61	92	14	63	47	38	21	18	30	21	40
Recertification Cases	....	....	....	....	....	....	....	....	65	572	320
Actions Taken:											
Withdrawal of Approval	15	29	2	4	8	10	3	3	27	268	314
Suspension	1	1	....	....	....	....	....	....	1	6	1

Fact Based Cases.—Are those referrals to the board as a result of a review of the lenders origination, underwriting and/or operations; primarily the result of the Single Family Quality Assurance Division's lender monitoring reviews, but the board also receives referrals from the OIG, Multi-Family, etc.

Recertification Cases.—Are referrals to the MRB from the Office of Lender Activities Lender Recertification branch and are the result of a lender's failure to follow our annual renewal process. The addition of this new category in fiscal year 2008 was primarily due to the new requirements issued from the decision by HUD's Administrative Law Judge in fiscal year 2008 that all lenders that do not comply with FHA's annual renewal requirements must go before the Board for administrative action.

Withdrawal of Approval.—Terminates the FHA-approval of a lender, e.g. lenders lose their FHA Approval Status and have no authority to originate and/or underwrite FHA loans.

Suspension.—Temporarily suspends an FHA-approved lenders ability to originate and/or underwrite FHA loans. It does not terminate their FHA Approval, just the ability to use it.

FHA SINGLE FAMILY INSURANCE EFFECT OF PROPOSED PREMIUM RATE CHANGES ON HOME BUYERS WHO MAKE THE MINIMUM CASH INVESTMENT

Home Price and Mortgage Payment Components	With Current MIP Values (175/55)	With Interim 225/55 MIP Plan	Difference from Current Values	With Proposed 100/90 MIP Plan	Difference from Current Values
House price—Average Value	$176,000	$176,000		$176,000	
Base Loan Amount (96.5 percent LTV)	$169,840	$169,840		$169,840	
Loan Amount with UFMIP	$172,812	$173,661	$849	$171,538	−$1,274
Interest Rate (percent)	5.50	5.50		5.50	
FHA upfront MIP rate (percent)	1.75	2.25		1.00	
FHA annual MIP rate (percent)	0.55	0.55		0.90	
Principal and Interest payment	$981	$986	$5	$ 974	−$7
PITI payment [1]	$1,355	$1,360	$5	$1,348	−$7
PITI + FHA Mortgage insurance payment (full mortgage payment)	$1,434	$1,439	$5	$1,475	$42

[1] This assumes that property taxes and hazard insurance payments (TI) amount to 2.55 percent of the property value. This figure is backed into from the difference between the average mortgage payment ratio of FHA-insured borrowers and the payment without the TI portion. PITI refers to principal, interest, taxes, and insurance.

Source: U.S. Department of HUD/FHA; February 2010. Average values are for FHA-insured home-purchase borrowers, October–December 2010.

DESCRIPTION OF HUD'S LOSS MITIGATION PROGRAM TOOLS

Formal Forbearance

A short term repayment plan to postpone, reduce, or suspend payment due on a loan for a limited and specific time period. A formal forbearance is normally entered into when a borrower is in imminent default or early delinquency and can be as simple as a promise-to-pay.

Special Forbearance

A long term repayment plan that may provide for periods of reduced or suspended payments when there is reasonable likelihood the borrower can resume normal or increased payments.

Mortgage Modification

Provides a permanent change in the monthly mortgage payment by capitalizing the accumulated arrears and establishing a new mortgage term of up to 30 years.

Partial Claim

A promissory note and subordinate mortgage to cover the advance for delinquent mortgage payments is issued in the name of the Secretary of HUD. Mortgagee advances funds on behalf of the Mortgagor in the amount of the Partial Claim advance to reinstate the delinquent loan.

FHA–HAMP

FHA–HAMP allows qualified FHA-insured borrowers to reduce their monthly mortgage payment to an affordable level by permanently reducing the payment through the use of a partial claim combined with a loan modification. The partial claim defers the repayment of a portion of the mortgage principal through an interest-free subordinate mortgage that is not due until the first mortgage is paid off. The remaining balance is then modified through re-amortization and in some cases, an interest rate reduction.

Pre-foreclosure Sale

Homeowner sells the property at a price less than the outstanding mortgage balance and HUD pays an insurance claim to the mortgagee for the resulting loss.

Deed-in-lieu of Foreclosure

Voluntary transfer of property title to the lender or directly to HUD.

PREPARED STATEMENT OF KENNETH M. DONOHUE

Chairman Murray, Ranking Member Bond, and members of the subcommittee, thank you for inviting me to submit written testimony today. I very much appreciate the opportunity to speak on the importance of the role of the Federal Housing Administration (FHA) in addressing the housing crisis currently confronting our Nation. It was a year ago, when I last testified before you on this topic and much has transpired during the intervening time as well as some aspects, such as the stagnancy of the housing market, unfortunately remaining the same. We have not yet weathered the economic storm but hopefully in its aftermath we will see some clearer skies and renewed prosperity. This much is known 1 year later however—the current degree of FHA predominance in the market still is unparalleled.

BACKGROUND

The mission of the Department of Housing and Urban Development (HUD) is to increase home ownership, support community development, and increase access to affordable housing free from discrimination. The FHA provides mortgage insurance to private lenders that finance single family homes, multifamily projects, healthcare facilities, loans for property improvements and manufactured homes. The FHA has provided mortgage insurance to over 37 million single family homes and over 51,000 multifamily projects since its inception over 75 years ago. Most of the industry has adhered to the FHA and industry standards in assisting the American home buyer. Unfortunately, there are those that seize upon the opportunity for "greed" in exploiting the system.

As I stated previously, the last number of years have seen enormous and damaging developments in the mortgage market: the dissolution of the subprime and Alt-A loan markets; dramatic drops in housing prices in most areas of the country; a concomitant rise in default and foreclosures arguably drawing comparisons to levels of distress experienced in the Great Depression; financial insecurity in the mortgage-backed securities markets represented by the Government takeover of Fannie Mae and Freddie Mac; the collapse of credit markets; and, as a primary vehicle to address these issues, an urgent reliance on the FHA to bolster the mortgage market.

The FHA was established under the National Housing Act of 1934 to improve housing standards and conditions, to provide an adequate home financing system by insuring mortgages and rental projects, and to stabilize the mortgage market after the devastation of the Depression and massive losses of home ownership during that time. It was created to be the standard setter and the standard bearer for the mortgage and housing communities in areas such as underwriting standards and ethical behavior. It had, in my estimation, as history will attest, abdicated this important role—too often slow on the upside, as we saw during the recent expansion of FHA in the marketplace, and slow on the downside. It had a responsibility which frankly it sidestepped.

HISTORICAL PERSPECTIVE

The FHA Commissioner in his testimony a number of weeks ago regarding policy and legislative reforms, stated that ". . . many of these reforms were long overdue as FHA did not respond effectively to changes in the marketplace that happened during the housing boom and the subsequent decline." In his view ". . . inaction was and is not an option." I applaud these remarks and state for the record that in my 8 years as HUD inspector general, this FHA Commissioner has tried to do more in the last year than I saw in all the previous years combined. As you know from my many years of testimony before this subcommittee and others, I agree with his statement that the "organization they inherited was simply not properly managing or monitoring its risk." Many of his proposals and initiatives are long overdue and meritorious. That said, we still have much to do and have much uncertainty facing this Department—some within the control of departmental officials and some outside their sphere of influence. While it is difficult to predict the future—as an old adage goes if you have five economists in the room you'll have eight different forecasts—I am not as optimistic as some are with where we are today or even going in the near future but I do agree that the program is attempting to move ahead in a good direction.

In late 2008, a BusinessWeek article generated a buzz with a picture of a wolf on the cover representing the pernicious side of the mortgage industry coming at the FHA. I was quoted at the time expressing my concern about the groundswell of loans that were going to come in to the program and the types of loans that might be coming with the onslaught of new lenders. The FHA disputed my statements. Also quoted in the article was Michael Ashley, a chief official of a New York mortgage lending firm who had switched its strategy from subprime to FHA-backed mortgages. The article reported that in 2008 alone the company, Lend America, made $1.5 billion in loans and Ashley is quoted as stating that the "FHA is a big part of the future." I was perturbed reading his blatant bravado regarding how the FHA had become his meal ticket because of our open investigation of him and his company at the time and our previous prosecution against him years earlier for engaging in similar activity.

When I highlighted this case to you in previous testimony, I was frustrated with the vulnerabilities in the FHA approval system that allowed Mr. Ashley to come back into the program and to publicly and brazenly brag about his participation. I am pleased to state, however, that we did receive an injunction against Mr. Ashley banning him permanently from ever engaging in Federal mortgage programs. A local newspaper reported when we took initial action against him that there was a Mercedes Benz car in the company parking lot with a license plate "RefiFHA." Hopefully, with the actions that the FHA is trying to put into place today we will not see such bombastic industry behavior. I am also pleased that this Commissioner has recently taken action against over 300 lenders sending a very distinct message to the lending community. I had highlighted in reports that the Department's Mortgagee Review Board was broken and I applaud his action to reinvigorate the process. I do think that this Commissioner is dealing with the consequences of departmental inactions that took place prior to his tenure and that our perceptions at the time have, despite the agency's attempts then at refutation, come to pass in terms of volume, types of participants, and ramifications to the portfolio.

For example, another recent OIG case underscores large fraud schemes and losses to the program. At Taylor Bean and Whitaker (TBW) Mortgage Corporation and Colonial Bank we uncovered various schemes. Federal search warrants were simultaneously executed at both TBW and Colonial Bank. The FHA then suspended TBW from participation and the company filed for bankruptcy. Colonial Bank was taken over by the FDIC and then sold to BB&T Bank. HUD's suspension was based on TBW failing to submit an audited financial statement, misrepresenting that there were no unresolved issues with an independent auditor and its failure to disclose it was the subject of two examinations into its business practices. At the point of seizure, TBW was servicing Federally insured and guaranteed loans with a remaining principal balance of about $26 billion.

Lastly, I had said that, through the multitude of our work in auditing and investigating many facets of the FHA programs over the course of many years, we have had, and continue to have, concerns regarding FHA's systems and infrastructure to adequately perform its current requirements and services. This was expressed by the OIG to the FHA through audits and reports regarding a wide spectrum of areas prior to the current influx of loans coming into the program and prior to the consideration of the numerous proposals that expanded its reach. Some of these were longstanding concerns that went back to unresolved issues highlighted in our work products from as far back as the early 1990s.

THE CURRENT LANDSCAPE

The past 2 years have certainly produced a lot of changes and initiatives. In response to increasing delinquencies and foreclosures brought about by the collapsing subprime mortgage market, the FHA Secure program to refinance existing subprime mortgages, the Housing and Economic Recovery Act's (HERA) Hope for Homeowners program, the Helping Families Save Their Homes Act, and The Making Home Affordable Program were created to assist homeowners.

As we turn to today's environment, the size of the Single-Family FHA-insured loan portfolio has enlarged by nearly 50 percent from $466 billion in fiscal year 2008 to over $697 billion in fiscal year 2009. During the month of March of this year, the FHA's total mortgage in force was over $6.1 million with an aggregate outstanding balance of over $800 billion. Single-Family market comparisons from the first quarter of fiscal year 2010 show that FHA's total endorsements have increased to 74 percent of the insured mortgage market which includes both home sales and refinances. As recent FHA testimony states, the FHA program is insuring almost 30 percent of purchases and in the past year alone helped more than 800,000 homeowners refinance.

I still remain concerned that the FHA will be challenged to handle its expanded workload or new programs that require the agency to take on riskier loans than it historically has had in its portfolio. The surge in FHA loans is overtaxing the current infrastructure, making careful and comprehensive lender monitoring difficult. Through our cases we see the consequences of allowing in dubious lenders who then inflicted the program with problematic loans. In addition, our experience in prior high FHA volume periods (such as from 1989–1991 and 1997–2001) shows that the program was vulnerable to exploitation by fraud schemes, most notoriously flipping activities, that undercut the integrity of the program. I support many of the recent initiatives proposed by the Secretary and the FHA Commissioner, of which I will elaborate on later, and a new departmental attitude to address these issues head on.

We testified last year that the FHA had to contend with a significant and complex situation in balancing the risks to, and fiscal vitality of, the Mutual Mortgage Insurance (MMI) Fund against the need to assure financial mortgage markets continue to function properly during the downturn of the economy. Among the issues we spoke to were the adequacy of resources available to FHA for staffing, training, oversight, and system enhancements. We cited the increasing risks the FHA faced that needed to be addressed by both its front-end risk assessment processes as well as its back-end monitoring and corrective action processes.

Since that time the FHA has undertaken a number of actions to mitigate some of those risks and protect reserve fund balances. The FHA has banked on the accuracy of its actuary's projections in assessing the health of the Fund and has faith that it is experiencing improved performance with its 2009 and 2010 portfolio. Economists cannot agree the direction the economy is going and I equally am not a proficient prognosticator. We are in a fluid and dynamic situation that too often has not been predictable or readily knowable. The FHA, like the average American, is still searching for clearer horizons and a break in the tempest.

The FHA's latest report shows that for last quarter, the net losses on claims were averaging close to 60 percent which is 13 percent higher than was predicted. In layman's terms, the FHA is recovering only 42 cents on the dollar (i.e., what it loses after it pays a claim and sells foreclosed property). In the State of Michigan, however, it is only recovering 16 cents on the dollar. It currently has approximately 45,600 properties at a value of $5.7 billion in the real estate owned (REO) inventory. Moreover, its credit subsidy rate is one-half percent which after adjustment for present value means revenues are a one-half percent ahead of claims. That's positive but by a very slim margin. The FHA is taking a number of steps to mitigate losses and keep the fund positive.

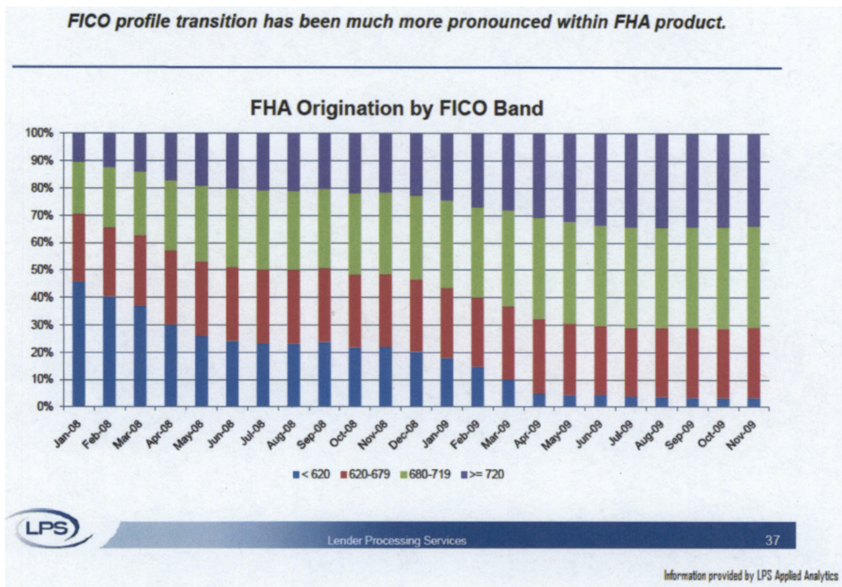
While the FHA's confidence in actuarial numbers brings it hope, we believe vigilance is needed until the marketplace has stabilized. Like any American family in today's uncertain times, the FHA will have to continuously monitor its financial position and take proactive steps to keep ahead of the curve when reality dictates corrective action is required. The FHA has a number of tools at its disposal to increase revenue or to reduce losses accomplished through mechanisms such as loss mitigation or vigilant oversight of lenders and brokers. Most of the major actions proposed to mitigate risk will not go into effect right away so we need to understand that such actions may have little effect on loans already in the portfolio. With the current state of the economy, will there be enough new loans to bail out the old loans? This is where due diligence today is imperative as well as an overall proactive approach.

FHA POLICY CHANGES TO ADDRESS RISK AND STRENGTHEN FINANCES

New Loan-to-value and Credit Score Requirements

Loans to borrowers with a credit score of less than 580 will require a minimum 10 percent down payment. Loans to borrowers with a credit score of 580 or above will require the traditional minimum of 3.5 percent down payment. This change, if approved, will go into effect this summer after going through the Federal Register notice and comment process.

We are in general agreement with the move to strengthen down payment requirements. We, however, believe there are some caveats. While this requires borrowers with the riskiest loans (below 580) to put more, to quote an earlier comment by Senator Bond, "skin in the game," this will more than likely have minimal impact on the Fund in terms of bringing in additional premiums. Loans for borrowers with credit scores below 580 are less than 1 percent of new activity. So these additional requirements may likely end most activity in this category. It might, however, reduce future claims but the volume of these loans will not bring in a significant amount of premium payments to cover current losses. The chart below from LPS Applied Analytics shows the proportion of FICO credit scores over the last 23 months.



As seen in the lowest color segment of the bar chart for FICO scores below 620, the percentage of loans that would be potentially subject to the new 10 percent down payment requirement has steadily decreased to less than 1 percent. This is both good news and bad news because it shows that from a financial perspective the FHA's riskiest business is falling off but from a social perspective the potential homeowners that it traditionally has served may be priced out of the market. Importantly, we are also seeing defaults and claims affecting higher credit score loan holders and there are some vocal advocates who think a higher down payment may be required for a wider spectrum of credit score categories. Further, the 580 credit score threshold is well into what is traditionally considered subprime territory in the conventional marketplace with 620 being the usual demarcation for subprime. We believe that to have a higher down payment requirement at the 620 level may have a more meaningful impact due to the larger volume of loans at this level.

In assessing the most recent year's book of business, it needs to be understood that underwriting is like a three-legged stool. FICO scores are only one leg—the other two legs are the value of the property and the future employment of the borrower. While it is true that FICO scores have risen from an average of 626 in fiscal year 2008 to 695 in the first quarter of fiscal year 2010, we should also note that the loan-to-value ratios have also gone up during this timeframe. In FHA's recent Quarterly Report, the loan-to-value ratio for the 96–98 percent category had risen from 48.8 percent of the loans written in the first quarter of fiscal year 2009 to 69.1 percent in the first quarter of fiscal year 2010. This may mean that any gains realized from reduced risk for having higher FICO scores may be offset by the increased risk of higher loan-to-value ratios. In other words, borrowers are putting less of a down payment into purchased homes. As we said in previous testimony opposing seller-funded down payment assistance plans, less "skin in the game" often means that there are increased chances for the owner to walk away if delinquencies occur. Further, any benefit from the increase in the average FICO scores may be tempered by a commensurate rise in claims generated from those loans.

So while the FHA believes that they may have an improved book of business in terms of increased volume and FICO scores, the jury is still out if the additional cash generated by the new book of business will be sufficient to cover the unknown amount of losses in the short term or if the premise that high FICO scores are equivalent to soundly underwritten loans still holds. Economic instability is creating counter-intuitive trends in consumer behavior.

Up-front Mortgage Insurance Premium Increased to 2.25 Percent

The FHA is pursuing legislative authority to increase the statutory cap on the annual Mortgage Insurance premium. OIG supports this change in the premium structure. Any business needs to be able to adjust its pricing in order to continue to operate efficiently. The FHA needs the ability to adjust premium prices without requiring legislative action each time that may impede its ability to react quickly. The FHA will need, however, to ensure that a process is developed to link future insurance premium changes to actuarial forecasts.

Reduce Allowable Seller Concessions From 6 Percent to 3 Percent

The FHA is seeking an action to conform to industry standards and to reduce potential value inflation. It is anticipated to go into effect this summer after appropriate notice and comment time. The OIG supports this measure. We believe that the FHA needs to be consistent with industry practices so as to avoid pressure to raise prices to cover seller concessions.

Increase Enforcement Efforts to Ensure Compliance With FHA Guidelines and Standards

The FHA: (a) Will use a scorecard system to evaluate and report lender performance to compliment current information available from Neighborhood Watch data (this was implemented in Mortgagee Letter 2010–03); (b) will enforce indemnification provisions through section 256 of the National Housing Act and cover those loans found to contain material errors in underwriting (this is anticipated to go into effect this summer after posting and comment periods); (c) asked for legislation to apply section 256 to require indemnification provisions for all direct endorsement lenders in order that all approved mortgagees assume liability for the loans originated and underwritten by them; and (d) will move to increase capital requirements from $250 thousand to $1 million in 1 year, and then to $2.5 million after the final rule is published, and hold the lender responsible for the final underwriting.

We support the FHA's decision to enhance risk management by, among other things, hiring a senior level risk management officer. Its decision to use a scorecard system will certainly assist it in uncovering problem companies. We note that the FHA has returned to conducting a 5 percent sample of lender endorsement reviews by its contractors. The number had slipped to 2 percent last year because it could not keep up with the volume. We also support FHA's request for legislative authority to create separate areas for the purpose of review and termination under the Credit Watch Initiative.

The FHA's intent to strengthen enforcement of its indemnification provisions in section 256 is important to an overall enhanced enforcement strategy. OIG reviews of indemnifications found recovery was hampered by firms going out of business, thereby rendering some indemnifications worthless. In a recent OIG Inspection and Evaluation report, we found that the FHA serviced $187.5 million of indemnification and civil money penalty debt due from lenders for the period fiscal year 2005 through fiscal year 2008. The FHA collected $124.4 million or a 66 percent recovery rate (a collection rate that compares favorably with that of the Veterans Administration's Housing-Guaranteed and Insured Loans program and private collection agencies), however $8.7 million was uncollectable primarily the result of the debtor lender going out of business.

—*OIG Concerns Regarding Anti-flipping Waiver*.—One change the FHA recently instituted this year was the decision to waive its anti-flipping provisions for 1 year. This action was not vetted with us through normal departmental clearances and we, unfortunately, had no opportunity to opine on the matter. While we understand the underlying reasoning to turnaround foreclosed properties in a quicker manner, we believe its imposition may open a new round of fraud-related flipping abuse and we would have liked to express our concerns or to press for more compensating controls.

Current housing market conditions have created a bulge in HUD's real estate owned inventories that provide a ready source of properties for potential flipping schemes. To eliminate inventories, lenders and the FHA's own contractors often significantly discount the sales price from acquisition costs and appraisal values in a more normal housing market. The discounts provide the necessary margin for flipping opportunities, legitimate as well as illegitimate. Historically, the illegitimate flip involved a conspiracy between investors, loan officers and appraisers, allowing for the financing of the re-sale to be done at an inflated value, justified by market conditions of increasing housing values.

When the anti-flipping rule had been originally promulgated, the FHA, primarily at the request of the OIG, sought to protect the MMI Fund from this vulnerability by prohibiting financing of property re-sales until 90 days had elapsed after the purchaser acquired the property. This waiting period effectively protected the FHA from flip abuses such as "double escrows" and same day closings. The FHA states the waiver is designed to help reduce REO inventories. There is, however, a real risk that the waiver could serve as an invitation to investors willing to engage in abusive schemes or to try to skirt the rules. Indeed, we almost immediately saw discussions on the Internet among investors. Moreover, with the increase in the FHA's loan limits to greater levels, high-end, as well as traditionally low-end, properties could be targeted by the unscrupulous.

While an attempt was made by the FHA to mitigate improper activity by requiring an explanation of any price increase over 20 percent, as a law enforcement agency we know that it can be just as easy to fabricate documents for this as it can be to inflate the appraisal itself. We see little to deter the wide-scale flipping that occurred before the practice was stopped by a 90 day waiting period. While we recognize that keeping the status quo may delay closing, we believe that it is preferable to the alternative risk that such an action may unleash. A safer approach may be to limit the wavier to GSE-held properties or to those sold through State and local rehabilitation programs such as the Neighborhood Stabilization Program where closer scrutiny of rehabilitation costs can be made.

—*Enhanced Up-front Reviews*.—We believe it is important that the FHA become more aggressive in the areas of monitoring and detection and analysis of red flags. We endorse FHA's Mortgage Fraud Initiative which seeks to use fraud detection technology to identify loans likely to contain fraudulent information. We have stated previously our belief that FHA needs to take advantage of commercial off-the-shelf pre-screening loan software. We have also long voiced our concerns that the process to become an FHA approved lender and correspondent was not rigorous enough to keep out the known bad actors. When the conventional markets started to decline, we expressed our concern that the same individuals and companies that precipitated the conventional market collapse would seek shelter in the FHA markets and use similar tactics that led to poor underwriting. We believe that this did in fact occur.

In the case which I referred to earlier in this testimony regarding the New York company Lend America, Michael Ashley, who carefully did not place himself as a principal in the firm but as a business strategist, had had a long history of legal troubles (including with the HUD OIG) and was working as a top manager for one of the most rapidly growing lenders in the FHA's portfolio. Court filings show that Ashley fostered an environment that encouraged sales staff to originate FHA loans even when the borrowers were not eligible. Sales staff could make 10 times the commission on FHA loans than on standard mortgages and almost 4 times the commission than on a subprime loan.

Mr. Ashley pled guilty in 1996 in Federal court to two counts of wire fraud relating to a mortgage scam at another company his family once owned. He was sentenced to 5 years probation and ordered to pay a fine and his father was sentenced to nearly 4 years in prison. He appealed his suspension and debarment with HUD which later was reduced to a ban that expired in 1998. Once served, the FHA allowed him to resume operations. He then went to another firm that again HUD issued a notice of violation. After leaving that firm, he became affiliated with the most recent company. Although this case is still open, it is clear to say that the Federal court would not have permanently banned Mr. Ashley if it were not concerned about the current operations of his affiliated company. The President of the company was also debarred at the same time but for a specific period of time—in this case 18 months.

This again calls for the establishment of a new mindset at the FHA to know your participants and not just the entity. It can be a very arduous process for the OIG acting as the investigators for the Department of Justice to work to get a court-ordered injunction. Mr. Ashley was quoted in the press as grumbling that the inspector general's office tried its best to constantly go after him and put him out of business. Although he was complaining to the judge at the time, his quote is revealing in that we had to keep following him from one dubious enterprise to another. It can be frustrating. If current regulations and statutes are impeding the FHA's ability to create a watch list or to know its providers complete backgrounds or to keep out permanently those from entering whom it does not want to participate in its program—it has a duty to let Congress know it needs legislative relief to enhance its administrative remedies (i.e., more permanent debarment authority, enhanced civil monetary penalty fines) in order to accomplish this goal. I do not believe in years past, when it was striving to increase its market share, that this was a goal. But I do believe that with the large influx of loans and lenders coming at the program recently it may now see how imprudent such inaction can be.

A systemic weakness revealed in this case and others showed that FHA-related monitoring and oversight reports typically cited the lending firm without naming the individuals associated. The FHA had argued that without specific citations against individuals it could not link principals of a defunct company to those same individuals who would go on to form new entities. We see this type of maneuver too often and it makes the FHA program too easy a target for those intent on abusing the program. We recommend that FHA ensure in a more significant way that those individuals affiliated with lender entities (either as principals or as staff) are clear of indictment, conviction, debarment and suspension, limited denials of participation and unpaid Federal debt before applications are approved.

The FHA should also consult with other HUD offices to determine whether applicants are subject to unresolved findings and ensure that application fees received are reconciled with the related applications. More importantly, if the Mortgagee Review Board concludes that a company has participated in improper activities and recommends removing the company's ability to participate in the FHA loan program, the Board also needs to recommend permanent removal of the principals and other individuals involved from any future FHA and HUD programs. I know in my conversations with the Commissioner this is an area on his radar screen.

The Commissioner testified at his recent hearing, and I lauded earlier in my testimony, that over the last year the FHA has withdrawn 300 licenses from poor performing lenders. We believe that many of these could have been screened more vigorously at the time of their application before the consequences of their admission came to bear in terms of losses or resources applied to investigate and to prosecute. Only time will tell how many more significant failures are yet to be uncovered but we do see more on the horizon. We believe that more stringent requirements, in addition to enhanced net worth requirements, are needed to keep predatory firms and individuals from conducting FHA business.

I would like to take the opportunity to also draw a parallel issue with the Government National Mortgage Administration (Ginnie Mae) approval process. We believe Ginnie Mae equally needs to strengthen its approval process. While the funding level for its reserves are in a better financial position than that of the FHA, it too has experienced increasing default rates and has suffered unusual substantial losses due to the failure of Taylor, Bean and Whitaker and Lend America. More due diligence needs to be done by Ginnie Mae in approving and recertifying its issuers and I look forward to seeing meaningful recommendations for statutory and regulatory improvements akin to what the FHA has recently proposed. It also has to shift its mindset away from a business-oriented mentality to let problem issuers remain in the program while they work out the details. This attitude toward the industry is no longer feasible unless it wants to absorb large losses. I will speak more to my concerns with Ginnie Mae later in the testimony.

We commend the FHA for endeavoring to expand its enforcement and note that it has very much needed to implement a more robust early warning system that would alert FHA to precipitous sales price increases. We also see the need for FHA to enhance its Neighborhood Watch system (i.e., allow for tracking of information relating to loan officers, loan processors, and real estate agents) and the Credit Watch Termination Initiative.

—*Lack of Affirmative Certification Statement*.—In this same vein, we would like to update the subcommittee on a matter we brought before you a year ago. At the time, I shared with the members an exhibit showing the current application form to become an approved FHA lender or Ginnie Mae issuer. I pointed out to the subcommittee that unlike the Ginnie Mae section which contained an affirmative statement that required the applicant to attest that they had not knowingly made a false statement and could be subject to applicable civil or criminal penalties, and despite the large volume of new applicants coming into the FHA program, the FHA certification and recertification inexplicably contained no such requirement. Even more puzzling is the FHA's response from the Director of the Office of Lender Activities to my recommendation in an audit of the lender approval process. The FHA stated it did not agree with the finding and stated that "the OIG has not sufficiently demonstrated that because of its certification language FHA is unable to successfully take legal action against lenders violating its program requirements" and requested its removal from the audit.

The Department of Justice as chair of the National Procurement Fraud Task Force has recommended that all agencies put in language for grantees of Federal funds the requirement that the participant certify that the statements made in the application are true and correct and that it understands that any false statements made as a part of these certifications can be prosecuted.

Requirements to Better Manage Brokers Such as New Rules for Audited Financial Statements and Adequate Capitalization

OIG supports this initiative. We also believe that the annual financial statements for lenders lag too far behind to be useful. We believe there should be quarterly unaudited financial statements similar to the SEC's publicly-traded company requirement and suggest that there also be an effective review process of these statements. Billions of dollars flowing through the FHA are riding on the financial health of these firms. Timeliness of information is essential in making decisions and we would encourage such a change.

OPERATION WATCHDOG

On January 12, 2010, FHA Commissioner Stevens and I jointly announced a new OIG initiative focusing on mortgage companies with significant claim rates against the FHA mortgage insurance program. This initiative was prompted in part by the Commissioner who was alarmed by the incidence of excessive default rates by a number of poor performing FHA lenders and reached out to the HUD OIG for assistance. Our office served subpoenas to the corporate offices of 15 mortgage companies in 11 States across the country demanding documents and data related to failed loans which resulted in claims paid out by the FHA fund. We identified these direct endorsement companies from an analysis of loan data focusing on companies with a significant number of claims, a certain loan underwriting volume, a high ratio of defaults and claims compared to the national average, and claims that occurred earlier in the life of the mortgage. These may be key indicators of problems at the origination or underwriting stages. The firms were not selected for indications of wrongdoing on their part but we will aggressively pursue indicators of fraud if they should be uncovered during the analysis. We are a principal member of the President's Financial Fraud Enforcement Task Force and this initiative reflects our commitment to seek information on red flags that may arise from data analysis.

While we are still in the data recovery and analysis phase, and cannot discuss at this time the initial results of our review, we do believe that this initiative will continue. We will carry out our line of inquiry until we have conclusive results to provide to the FHA, to the Congress and to the American taxpayer. It is important to know for the long-term viability of the FHA program whether these skewed high claims and default rates are a result of a weak economy or if companies are ignoring, or even purposefully violating, FHA regulations. We want to send a very distinct message to the industry that as the mortgage landscape has shifted, we are watching very carefully, and that we are poised to take action against bad performers. The American taxpayer demands, especially after the lessons of the subprime collapse, that oversight and monitoring must be rigorously implemented. While we may disagree from time to time with some of the actions the FHA has taken, we both share a common resolve to preserve home ownership at the same time as protecting the American taxpayer from further economic instability.

In an audit on Single Family insurance claims, we found that the Department received and paid claims on loans for which the lender did not show the borrower was able to make the required monthly payments, made the minimum investment in the property, and was creditworthy. It paid the claims and did not review the loan files for compliance with requirements, fraud, and/or misrepresentations. Our initial review under Operation Watchdog reinforces the concerns we found in this claims audit. The Department should review claims for eligibility and, if feasible, independently determine that loans comply with program requirements and seek, from lenders, recovery or adequate support for final costs associated with those claims.

Loan Binder Retention.—One issue that has arisen in our reviews of these poor performing lenders is the ramifications of the prior administration's policy to allow lenders to maintain original records. Through the issuance of a Mortgage Letter in 2005, the FHA enabled certain direct endorsement lenders to endorse FHA loans without a pre-endorsement review and generally relieved those lenders from the responsibility of submitting loan origination case binders to the FHA. The Federal Bureau of Investigation (FBI) and the HUD OIG, vigorously opposed the FHA's directive (as did HUD's own General Counsel at the time) to allow lenders the ability to retain documents. As a law enforcement and auditing agency, we were concerned that such a relaxation of control would hinder our ability to gather information for evidence if documents were tampered with or destroyed. Further, the guidance allowed lenders to maintain the files for only 2 years after closure. Statutes of limitations run 5 years in criminal fraud and generally 6 to 10 years in civil fraud matters.

Unfortunately, our fears expressed then in testimony and in a letter-writing campaign are indeed coming to fruition today. As we proceed with Operation Watchdog, we have had difficulty obtaining files from a number of these lenders including encountering instances of missing case files despite OIG subpoena demands. We strongly recommend that the FHA again revisit this directive to ensure information critical to the loan origination and underwriting process is available for detection of issues and/or potentially fraudulent activity. In a time when the American public demands our mortgage industry is free of waste, fraud and abuse, such a policy change is essential.

FHA FINANCIAL CONDITION

The results of the latest actuarial study produced last fall show that HUD has sustained significant losses in its Single Family program making a once fairly robust program's reserves smaller. The study shows that the FHA's Fund to cover losses on the mortgages it insures is contracting. As of September 30, 2008, the fund's economic value was an estimated $12.9 billion, an almost 40 percent drop from over $21 billion the year before. By September 30, 2009 the reserve level dropped below the statutorily mandated 2 percent requirement to 0.53 percent. The Fund's economic value was $3.64 billion compared to the $685 billion of outstanding insurance in force.

Since its inception in 1934, FHA has been self-sustaining and premiums paid to the fund have covered the losses due to fluctuating defaults and foreclosures. We testified last year that given the current economic conditions, it is critical that the assumptions used to derive the current estimate of the health of the fund be supportable and not overly optimistic. We stated to the FHA during our audit of its financial statement that the model embraced by the FHA should include the study of past and current delinquencies and the ultimate resolution as to cures or claims. The current model is designed for long term claim projections and is based on historical claims paid experience. Therefore, the model does not reflect recent delinquency development and lacks the corresponding adjustment to the claims paid. We recommended that the FHA expand its financial cash flow model validation to include seriously delinquent aged loans data, case level historical recovery data, and other leading indicators; and to track reasons for default and determine whether other economic indicators, such as unemployment claims, may be useful to support near term estimates for claim payments.

An assessment of the first quarter of fiscal year 2010 shows some trends that merit examination. With FHA's greatly increased Single-Family insured volume (a 24 percent change from the prior year and currently at more than three-fourths of a trillion dollars in insurance) comes an increasing default and claims paid rate. Add to this an increasing inventory of real estate owned properties that are managed by the FHA—with a falling recovery rate that has FHA now only recovering slightly more than 40 cents on the dollar and a "days in inventory" average of close to 200 days—and the picture becomes more disquieting. A significant problem facing the FHA, and the lenders it works with, is the fallout from decreasing home values. This increases the risk of default, abandonment and foreclosure, and makes it correspondingly difficult for the FHA to resell its REO properties.

Approximately 8.8 percent of FHA loans are currently in default (i.e., more than 90 days non-payment status, foreclosure or bankruptcy), an increase from the prior fiscal year to date. A major concern is that even as FHA endorsement levels meet or exceed previous peaks in its program history, FHA defaults have already exceeded previous years. Claim rates have also increased and though numerically still quite small, it must be noted that many of the new defaults are still in the pipeline. We may see increasing claim rates on the horizon. The Secretary and the Commissioner hope to stave off the consequences of this trend with new approaches to business, but the congressional and executive branch budget offices' disagree with the impact of these approaches.

In our estimation, this only reinforces the importance for FHA-approved lenders to maintain solid underwriting standards and quality control processes in order for the FHA to withstand severe adverse economic conditions. Another extensive problem confronting the FHA has been its inability to upgrade and replace legacy (developed in the 1970s and 1980s) application systems that had been previously scheduled to be integrated. The FHA systems environment remains at risk and must evolve to keep up with its new demands though there has been increased funding and new plans formulated. I know in my conversations with congressional staff that they are frustrated with the amount of resources expended and the pace with which such replacement plans have proceeded over the years.

INCREASED RISKS TO FHA

Mortgage Fraud.—Last year during testimony before this subcommittee, I highlighted a variety of traditional mortgage fraud schemes impacting both the FHA and the conventional loan market including schemes in areas such as appraisal fraud and loan origination fraud, and identity theft as well as new forms of fraud such as rescue or foreclosure fraud (to include equity skimming and lease/buy-back plans), bankruptcy fraud, and Home Equity Conversion Mortgage (reverse mortgage) fraud (to include schemes involving flipping, annuity sales, unauthorized recipients, and onerous fee payments/consumer fraud). As the Department of Justice recently testified, all types of mortgage fraud are on the rise and we are working closely with other agencies in the President's Financial Fraud Enforcement Task Force and as part of the National Mortgage Fraud Team. We currently have over 2,290 case subjects involving Single Family investigations. We have also recently created a more robust civil fraud enforcement initiative to assist the Department of Justice in enhancing civil mortgage anti-fraud prosecutions. For example, we recently assisted the Department of Justice in filing a complaint against Capmark Finance Inc, a large originator of HUD-insured loans, for making false statements in connection with applications used to acquire two nursing home facilities (a discussion of nursing home issues appears later in this testimony). The following represents a sample of a few of the criminal fraud cases we have recently pursued:

—In Operation Mad House, we conducted an undercover investigation to deal with the problem of escalating mortgage fraud in the Chicago area that had consistently placed it as one of the top five geographic areas for fraud. We received allegations that a number of mortgage operatives were involved in loan origination fraud including the creation of fictitious bank statements, false employment and inflated appraisals and we targeted an organized group of real estate industry professionals at all levels. We tracked the inflated appraisal and phony origination as well as the closing proceeds and how it was distributed. This investigation resulted in 22 individuals in 9 separate indictments being charged with multiple counts of fraud and a spin off whereby 4 new subjects were indicted late last year. All told, 26 principals in the mortgage industry including attorneys, brokers, loan officers, loan processors, appraisers, recruiters, and accountants have been charged.

—Earlier this month in Atlanta, three members of a reverse mortgage fraud ring were indicted by a Federal grand jury for altering real estate records, using fake documents, and posing as realtors in an abuse that took money away from qualified seniors. The defendants in this case faked required down payments by senior citizens to establish the equity needed in the home to qualify for the reverse mortgage. They did this by using bogus gift letters in amounts between $50,000 and $105,000 and using fake HUD–1 Settlement Statements reflecting the sale of non-existent assets closed by fictitious law firms to show the source of the required down payments. All the down payments were actually supplied by the defendants, not the senior citizens, to be returned to the defendants upon the reverse loan closings along with profits far in excess of the true sales prices of the properties. Such payments were disguised as seller proceeds or lien payoffs and all the mortgages contained fraudulently inflated appraisals.

—In another reverse mortgage case, on April 13, 2010, in Kansas City, Missouri, the Jackson County Prosecutor charged an individual with financial exploitation of an elderly/disabled person and forgery related to a fraudulent HECM (home equity mortgage conversion) loan. Our investigation revealed that the defendant allegedly obtained a quit claim deed on a Kansas City property belonging to an elderly man suffering from Alzheimer's disease and subsequently took out a fraudulent reverse mortgage in the victim's name. As a result of the scheme, the defendant deposited, by means of a forged Power of Attorney, reverse mortgage proceeds into a personal bank account as well as obtained a loan against the victim's life insurance policy.

—In February of this year, the former president of a mortgage company was sentenced in Federal court in California to 156 months in jail, 5 years probation and ordered to pay almost $30 million in restitution to victims for a fraudulent loan origination scheme that knowingly caused loan applications containing fraudulent documents to be submitted to various lenders for FHA insurance so that unqualified mortgagors would appear qualified. His actions caused over 900 fraudulent loans to be FHA insured and subsequently default resulting in a substantial loss to the program.

Nursing Homes/Section 232.—The FHA insures mortgage loans (section 232) to facilitate the construction and rehabilitation of nursing homes, intermediate care facilities, board and care homes, and assisted living facilities. It also allows for the purchase or refinancing of existing projects not requiring substantial rehabilitation. It insures lenders against the loss on mortgage defaults. As of the end of calendar year 2009, HUD had 2,327 projects with an outstanding principal balance of $14.6 billion. This represents close to a 36 percent increase in projects receiving initial endorsements from the previous year. As we noted in last year's testimony, the current section 232 regulatory agreement does not prevent transfer of the Transfer of Need associated with the property; does not include receivables in any security documents (which is a significant asset to the properties and can limit HUD's loss when retained); and does not require a lessee operating the project to abide by the same requirements as the owner. This allows lessees to use project funds for non-project expenses to the point of default with no recourse.

With such a vulnerable population involved, the OIG has been recommending for years in numerous audits and investigations that the regulatory agreement needs to be changed. This status has not changed since approximately the fall of 2006. It is our hope that this can be done expeditiously.

Appraiser Oversight.—Our review of the FHA appraiser roster identified critical front-end weaknesses as evidenced in the quality control review and monitoring of the roster. The roster contained unreliable data including the listing of 3,480 appraisers with expired licenses and 199 appraisers that had been State sanctioned. In a further review, we found that HUD's appraiser review process was not adequate to reliably and consistently identify and remedy deficiencies associated with appraisers. The FHA's current Single Family insured exposure totals over $800 billion representing over 6 million in FHA insured mortgages. Inflated appraisals correlate to higher loan amounts. If the properties foreclose, the loss to the insurance fund is greater.

With significant increases in volume and new responsibilities in the mortgage marketplace, and appraiser fraud a significant problem highlighted in national studies, we do believe it may be time for the Department to return to an FHA Appraiser Fee Panel similar to the one dismantled by statute in 1994. It is essential if the mortgage industry wants to overcome perceptions regarding its integrity and its role in the current economic crisis that it ensures true market values are correctly estimated. Such a move would relieve pressures on appraisers to return predetermined values and would change a system based on misplaced incentives. A study indicated that 90 percent of appraisers had felt pressure "to hit the number" provided (i.e., on the sales contract). The old FHA Fee Panel was rotational and guaranteed work as long as the appraiser met certain HUD requirements. As can be deduced from the many cases and problematic issues discussed in this testimony, inflated appraisals often are at the heart of the scheme or of the questionable arrangement.

Late Payment Endorsement Requirements Changed.—Last year, we testified on results from a number of other key audits that have noted significant lender underwriting deficiencies, inadequate quality controls, and other operational irregularities. We spoke to an audit in which we analyzed the impact of FHA late endorsement policy changes affecting FHA insured loans. Unfortunately, this still remains an issue and bears repeating. On May 17, 2005, the Federal Housing Commissioner issued Mortgagee Letter 2005–23, which significantly changed the requirements for late endorsements for Single Family insurance. A request for endorsement is considered late whenever the loan binder is received by the FHA more than 60 days after mortgage loan settlement or funds disbursement, whichever is later. The Mortgagee Letter removed the prior 6-month good payment history requirement for these loans and provided an additional 15 days grace period before the current month's payment was considered late.

We conducted a review of this rule change and found that, although FHA asserted the change did not materially increase the insurance risk, FHA did not perform a risk analysis to support this determination. Our review of the performance of loans from seven prior OIG late endorsement audits (i.e., Wells Fargo, National City Mortgage, Cendant, etc.) found a three and one-half times higher risk of claims when loans had unacceptable payment histories within the prior 6 months. Since the issuance of the Mortgagee Letter, we found that the default rate for loans submitted late had increased and was significantly higher than the default rate for loans submitted in a timely manner. The HUD Handbook itself acknowledged the risk of unacceptable payment histories by stating that "Past credit performance serves as the most useful guide in determining a borrower's attitude toward credit obligations and predicting a borrower's future actions."

In 2006, we recommended that HUD rescind the Mortgagee Letter until appropriate rule changes could be designed that were supported by an adequate risk assessment. The FHA disagreed with our audit report and declined to implement the recommendations. We referred this matter to HUD's Deputy Secretary who concurred with our recommendations on February 27, 2007 and ordered the FHA to immediately rescind the Mortgagee Letter.

Initially, the FHA agreed to implement the Deputy Secretary's directive but failed to take action, instead taking efforts to again dispute our audit results. This continued until April 2008, when the Deputy Secretary's office again intervened, at our request, and instructed the FHA to publish the proposed rule change in the Federal Register reinstating the 6 month payment history requirement for late endorsements. In June 2008, the proposed rule change was published in the Federal Register for comment.

Although the final rule rescinding the Mortgagee Letter was never published, FHA nevertheless closed the audit recommendation. In a memorandum dated March 18, 2009, we informed the FHA that, given the amount of time that had lapsed and the absence of a corrective action, the OIG would report this in our next Semi-Annual Report to Congress. Given the current mortgage crisis, concerns over losses to the insurance fund, and requirements for transparency, we believe that this is an important recommendation that should not be dismissed.

Capturing Key Information in, and Upgrading, Data Systems.—Another major concern, touched on previously in testimony, is the integration and upgrading of FHA legacy systems which bears repeating since our original premise has not been acted on. While there has been much discussion of an overall plan, and what particular types of systems are needed to go forward, it would be useful at this juncture to reposition the discussion to ascertain which data should actually be collected, and maintained, in the system in order to control the new demands placed on the program. Our audit work and our investigative "Systemic Implication Reports" transmitted to the Department over the years, makes it clear that, at a minimum, we need the system to track identifying information on key individuals involved in the transaction such as the originating loan officer, loan processor, and real estate agent.

The loan officer, for example, is central to the origination of the loan where due diligence should be exercised on the application material (i.e., credit scores, appraisal information, etc.). It would be useful to record the person's name and corresponding identifying information (i.e., license) in the same system the FHA uses to track underwriter and appraiser details. This will allow the FHA and OIG to key in on a vital part of the loan process—origination—where fraud typically can occur. If the system could also capture information on other key players such as the real estate agent for the seller and buyer, and other parties to the transaction, that too would be helpful for purposes of increasing integrity in the processes in our investigative and audit functions. It would also be valuable to the FHA in strengthening its risk management and monitoring efforts.

Further, it could be beneficial for the FHA to participate more significantly in a unified lender oversight consortium with Fannie Mae, Freddie Mac, the Federal Deposit Insurance Corporation (FDIC), and Ginnie Mae in order to, among other things, create standardized forms that could produce common machine-readable data fields with consistent information as well as to leverage existing data systems.

Earlier in the testimony, we described the TBW case and the weaknesses that it exposed in the FHA and the Ginnie Mae programs. As we are discussing the need for Federal entities to come together in a more unified manner, we would also like to highlight an issue that came to forefront in this case. Ginnie Mae mortgage-backed securities (MBS) are the only MBS to carry the full faith and credit guaranty of the United States. If an issuer fails to make the required pass-through payment of principal and interest to MBS investors, Ginnie Mae is required to assume responsibility for it. Typically, Ginnie Mae defaults the issuers and assumes control of the issuer's MBS pools.

The FDIC temporarily froze the Ginnie Mae custodial bank accounts at Colonial Bank as well as the bank's mortgage payment lock box account. As a result, Ginnie Mae was forced to make an approximately $1 billion pass-through payment (principal and interest) to investors. There needs to be better coordination between the FDIC and other Federal Government agencies so that losses absorbed because of its action can be mitigated by more cooperative and forward-thinking behavior. We are also very concerned with the extent that future bank failures and bankruptcies could have on the Ginnie Mae program. The FDIC stated in a recent report that over 200 banks are predicted to fail this coming year.

The other disconcerting aspect of the TBW case involves the fact that Fannie Mae became aware of some unsettling practices at TBW, made it replace some loans and then stopped doing business with it. TBW then sold their servicing rights to another company and started doing business with Freddie Mac. Then, down the line, Ginnie Mae accepted pools from TBW. It appears that Fannie Mae's only interest was self-interest. A number of years ago, I testified before the House of Representatives regarding a case called First Beneficial in which Fannie Mae did not tell other entities of its discoveries at First Beneficial and then, by its silence and inaction, caused losses to the Ginnie Mae program. There needs to be mandated requirement of notification and penalty for failure to notify or we will continue to see instances of fraud cases being perpetrated on unknowing securitizers.

CONTINUING CONCERNS

Though there have been incremental increases in funding to the FHA for a variety of staffing and system needs, including a planned increase of over 100 FTEs from fiscal year 2010 to fiscal year 2011, we believe there remains a need for either more, or a proper placement of, resources to the FHA in light of the dramatic percentage of increased loan volume and of its increased relevance to the eventual stabilization of the conventional mortgage marketplace. We would like to see more personnel dedicated to the Home Ownership Centers, which are responsible for monitoring loan origination and servicing practices, setting underwriting standards, and overseeing the disposition of HUD-owned properties, as well as to headquarters systems and technology until the IT infrastructure can be put in place in order to manage the program changes, and away from such activities as marketing since FHA has already proclaimed it wants to retreat from such a prominent place in the marketplace.

We still remain concerned that increases in demand to the FHA program are having collateral implications for the integrity of Ginnie Mae. Like FHA, Ginnie Mae has seen an augmentation in its market share. For example, in December 2009, its Single Family issuances totaled nearly $40 billion and it had a remaining principal balance of over $880 billion. By comparison, its balance in December 2007 was exactly one-half at slightly over $440 billion. It too has stretched and limited resources to adequately address this increase.

CONCLUSION

Mortgage industry behavior was a precipitating factor in the present economic turmoil. As the Department has written about in its assessment of the foreclosure crisis, industry participants encouraged borrowers to take riskier loans with a high risk of default due to the high profits associated with originating the loans and packaging them for sale to investors. These lenders had little or no risk in the loan. There were many factors that made it possible for the mortgage market to make so many miscalculations and missteps. A primary factor was development during this period of the growth of the asset-backed securities market, which shifted the primary source of finance from Federally regulated institutions to mortgage banking institutions that acquired funds through the broader capital markets and were subject to much less regulatory oversight.

Clearly the regulatory structure was not changing rapidly enough to keep with the pace of growth. Fraud may have had a significant contribution and analysis shows that there was a lack of adequate underwriting controls by lenders to oversee brokers' activities. The general regulatory structure did not work to provide adequate oversight to oversee the origination and financing of mortgages. The consequences were high risk lending and a resulting surge in delinquency and default. The lessons of the conventional side of the industry should not be lost on that of the FHA and Ginnie Mae programs as they too are now experiencing increasing delinquencies, defaults and claims. And it should not be lost on those tasked with rectifying the vulnerabilities that clearly came to the foreground regarding the lapse in oversight of the Fannie Mae and Freddie Mac Government sponsored enterprises.

The conventional mortgage market is going back to the basics. It is embracing full underwriting standards including accurate verifications of income, employment and appraisal; it is demanding adequate cash down payments from borrower's own funds; and it is seeking rational debt-to-income ratios. Observations of current historic contagions of risk suggest that, in the marketplace today, yesterday's lower 600's FICO score is now today's higher 600's FICO score and that FHA's floor may be set too low. Nevertheless, this has to be weighed against the FHA's traditional mandate to assist homeowners that are low to moderate income and who may have poorer FICO scores. It also suggests that even high FICO borrowers with significantly distressed properties still default because of the rational choice to prevent years of principal payments just to break even. This makes it all the more important to have an active risk management department to monitor and rapidly develop policies as the traditional "black-boxes" adapt to the "new."

Finally, we remain concerned that, although not within the control of the FHA, the fact that our nationwide mortgage lending system is fragmented with separate players embracing differing requirements creates opportunities for waste, fraud and abuse that a more unified approach could potentially ameliorate. We have not seen enough progress or initiative to try to overcome the vulnerability that lapses in coordination among Federal entities creates. Of one thing, however, we are sure—those intent on unscrupulous behavior know full well how to exploit the weaknesses in the system and to profit from such disorder. We do very much look forward to the implementation of many of the Secretary's efforts designed to mitigate many of the difficulties we have been highlighting in the last number of years and to working with him and the Department to try to improve programs so increasingly relied on by our citizenry during these trying economic times.

As Chairman Murray has stated, stabilizing and improving the housing market is critical to the Nation's economic recovery but FHA's participation must be done in a way that it can effectively manage the loans that were made during the height of the housing boom so that it can provide a much-needed boost of liquidity to the market. We thank you for the opportunity to relay our thoughts on these important issues based on the body of our work and of our experience, and greatly appreciate the activities of the Congress to protect the Department's funds from predatory and improper practices and to ensure an effective response on oversight at this critical time.

MMI FUND

Senator MURRAY. Thank you very much, Mr. Stevens.

Let me just start. This is your first appearance before our subcommittee, but FHA has been the subject of annual hearings since I have become chairman here. And together, Senator Bond and I have sounded the alarm on FHA and the solvency of the MMI Fund, and because of our concern, we did provide FHA with additional resources both for IT improvements and for increased staffing in order to give FHA the tools that they needed to protect the agency from fraud and risk and make sure that taxpayers never have to subsidize these mortgages.

So I am, obviously, very concerned that FHA's capital reserve account has now fallen below the mandatory 2 percent required by Congress. In your testimony, you outlined several reforms that are designed to recapitalize the reserve fund and protect the solvency of the MMI Fund, some of which you said are already in place.

But I would like you to share with us what is the current state of the MMI Fund and how does it compare with the projections that were set forth in the audit that Congress got last fall.

Mr. STEVENS. Thank you for the question.

Let me just start with the—we released to you the first quarterly report of the fiscal year to Congress a month and a half or so ago. The second quarterly report will be released here in the next few weeks, so you will get some detailed information on the status of the MMI Fund.

In particular, the current total reserves are actually higher than we reported when we announced that we had fallen below the 2 percent statutory level for the capital reserve fund. So today we are sitting at about a little over $32 billion. When we reported in the fall, it was about $31 billion. So they have actually increased.

I will tell you that there are a couple of key drivers that will impact the fund the most. The first are, obviously, the real foreclosure numbers that will impact the real actual reserves in the fund. We are actually behind what was forecasted for the year at this point in time, but we did forecast that we would have 125,000 total defaults for the fiscal year, and given the trend line, I believe we still will be on track to hit the 125,000 number, based on the trend line that we are seeing now. But I do not expect us to exceed that number.

The other impact to the fund will be the severity rate or the recovery rate, however you look at that. While we have some concerns in that area, the current recovery rates are generally remaining on track with what was forecasted.

So in total right now, I would tell you that the overall dollars in the fund are growing, not shrinking, but we still remain on track with everything that was projected by the actuary when we released it in the fall.

Senator MURRAY. Do you know when you are going to hit that 2 percent level?

Mr. STEVENS. The forecast for the 2 percent level was forecasted to be in 2013, I believe. As you know and as I would strongly caution, there are so many moving parts in the market that go into these forecasts, that we could hit that sooner or later, obviously depending on market conditions.

One example I would give you. In our actuarial forecast, our home price index expected roughly a 9 percent drop in home prices in the first quarter of the 2010 fiscal year. That has not been realized. However, there is still enough instability in the market that we do not know when the new actuarial study is done for the next upcoming fiscal year, what the home price forecast will look like. And if stability is on the horizon, we could end up having a better view of when the capital reserve will be hit. If the forecast is worse, it could put in jeopardy our existing forecast, and those are critical components that we are watching closely.

RECOVERY OF LOSSES

Senator MURRAY. You noted in your testimony that most of the expected losses are the results of mortgages from previous years, and while you are limited in your ability to effect the performance of older loans obviously, you can hold lenders accountable for losses on FHA mortgages that were improperly or fraudulently underwritten. How successful have you been in recovering losses from some of those mortgages?

Mr. STEVENS. I think this is a real challenge, part of which is there are some limitations to what FHA is allowed to do. Fortunately, the inspector general has some additional authorities which have been implemented. I would tell you at this point that some of the measurements of that are the number of institutions that we have either withdrawn approval from or suspended completely. As was noted, there were 300 institutions in the fiscal year. There have actually been another 200 on top of that, in total well over 500 institutions that are no longer allowed to originate loans in the FHA.

Our ability to go after performance on previous book years, borrowing fraud or misrepresentation or violations of the law, continues to be somewhat limited, and that is why we are asking for additional approvals to go after institutions whether they are DE lenders or LI lenders to be able to require indemnification at the institution level and that will help greatly. I do commend the inspector general.

Senator MURRAY. That will take legislation.

Mr. STEVENS. That will take legislation.

But addressing fraud issues has been a significant concern of mine, and we have a lot more work to do going forward. Obviously, we made some great visibility with companies like Taylor, Bean & Whitaker, shutting them down in the first few weeks while I was on the job, and Lend America, which really required partnership with the inspector general to get done. And these were stand-out institutions, but what people do not see are the little institutions committing fraud like the reverse lender in Hawaii who was taking reverse mortgages out for seniors and investing them in their own annuity investment fund which they owned and operated. Well, we got them too. That's just not a big headline-maker.

And so it is a big job and it requires a lot of work. And that is why the first investment we are making on the technology front is in the fraud tools area. We released our RFP last week and it is a 30-day process. So we have bids coming in right now for that work, and that will be in the market hopefully as quickly as possible.

GSES REFORM

Senator MURRAY. Well, as we now work to reform Wall Street and the financial sector and prevent any future housing crisis, it is really clear that we have to address the future of the GSEs. During the housing boom, Fannie Mae and Freddie Mac kind of lost sight of their primary mission of facilitating liquidity for safe and affordable mortgages. Instead we saw their zeal for profit drive them to take some unnecessary risks.

So we know reform is necessary and there has to be a clear plan for ending this unlimited taxpayer assistance for Fannie and Freddie. I think we need a very thoughtful approach as we do this. We have to protect our American taxpayers, but thoughtful deliberation cannot turn into delay or inaction. And we need to see the administration recognize the urgency of reforming GSEs.

So I wanted to ask you, when can we expect to see the administration's plan for reforming the GSEs?

Mr. STEVENS. Senator, what I would respond by saying is to reiterate what you said in your opening statement, that this needs to be thoughtfully done with care not to disrupt the housing market, and we completely agree with that.

We strongly agree with the need for reform. We all recognize that the housing system and the role of the GSEs or whatever structure exists going forward will not be the same as it was coming into this crisis. That is clear.

And we support Senator Dodd's recommendation strongly to do a study with recommendations early next year.

So to that extent, everything we do now has to be very carefully balanced with the need not to disrupt the markets because the GSEs are playing a critical role in the issuance of mortgages and mortgage-backed securities to keep the market stable under the current format.

Senator MURRAY. Well, any kind of radical change in the role of the GSEs could also mean a dramatic change for FHA and Ginnie Mae, and I am concerned about the prospect of FHA taking on significant increase in new business, given all the current challenges we have.

How do you see FHA fitting into this debate?

Mr. STEVENS. Without question, the needs in the future of the housing finance system under any normal view would have to consider all the participants that in some way, shape, or form have involvement by the U.S. Government, whether that is Federal Home Loan banks, FHA, Ginnie Mae, Freddie Mac, Fannie Mae, and whatever other solutions ultimately get considered.

So the fundamental belief we have for FHA is in isolation. FHA plays a critical role, as it always has since the Depression, when it was first created. It is a countercyclical role. It has been consistent in the marketplace when other financing vehicles have not been available. Its role is too big today. It is unhealthy to run at 30 percent market share as it currently does. The emergence of private capital to be sustainable in a recovery market is absolutely the most important step to help FHA's role in the market begin to shrink back to more normalized levels.

Senator MURRAY. Thirty percent is too much. We all agree with that. What do you think the market share for FHA should be?

Mr. STEVENS. You know, I think targeting a market share for FHA is something that gets any institution in trouble, but I will say that 2 percent was also an unhealthy level. That was a sign of subprime mortgages and option ARMs and private label securities wrapped by rating agencies and sold into various debt obligations to unknowing investors. That was an unhealthy world as well.

So if you look back through normal times, going back through the decades of FHA, during traditionally stabilized markets, it typically runs in the 10 percent range, maybe low teens, and that is sort of the range where I think FHA would be shown as a healthy participant in the mortgage context.

Senator MURRAY. How long would it take us to get from 30 down to 10—low teens?

Mr. STEVENS. Well, I think that is why the dialogue is so frustrating, as you said in your opening comments, and both of you have articulated this concern about even decisions around the GSEs. We are in a very unique period now. Freddie Mac, Fannie Mae, and FHA are consuming about 95 percent of the mortgage finance system for single family housing, and we need private capital to emerge. The first sign, as you said, Senator Bond, in your comments, was that—or Senator Murray. I cannot remember whose comments—who made the point. But as the Fed steps out of buying mortgage-backed securities out of the market which have kept interest rates low, that range of movement in mortgage spreads will be a clear indication of the private sector's interest in getting back into the mortgage markets. And we will see. We have a variety of thought leaders that we have talked to.

Senator MURRAY. So we do not know what the withdrawal of these supports is going to be. Yet, we are all kind of looking out there. Do you have a guess what it is going to do to——

Mr. STEVENS. Guessing is a dangerous game. I have been in this industry for 3 decades.

Senator MURRAY. How about a thoughtful——

Mr. STEVENS. Here is my thoughtful view, Senator. I actually do not expect mortgage rates to back up as significantly as some of the extreme negative views are when the Fed steps out. That will be the first sign of health. The first-time home buyer tax credit ends here. The last applications are at the end of the month. It expires at the end of June completely. That will be an interesting move because 2.2 million Americans filed for tax benefits under the First-Time Homebuyer Tax Credit Act. And so that will be a next test.

Redwood Trust has already issued one mortgage-backed securitization in the private sector in the last couple of weeks. They are getting ready to do another one. The trade levels of those trusts we are looking at very closely.

Each of these are indicators to me as to what will happen. Having been through a lot of—I lived in the oil patch crisis in Colorado and had branches in Missouri at the time many, many years ago working for a bank, and I do recall the impacts of going through that kind of cycle. You know, it takes confidence for investors to return. Private capital will come back when they believe there is strong regulation, that the rules of the road are clear, and that they believe that home prices are past the point of severe instability. There will always be variations, but stability is what people will invest in. The markets do not like instability whether it is in the equities markets or in the housing market.

Senator MURRAY. Thank you very much.

Senator Bond.

FHA LOSSES

Senator BOND. Thank you very much. Your questions and your responses raised a whole bunch of interesting areas.

Let me start off. What are the current losses that FHA is realizing under the MMI Fund? How does it compare to last year, and what is your projection for the future?

Mr. STEVENS. If you give me just a moment, I would like to be as accurate as possible.

Senator BOND. Okay.

Mr. STEVENS. So through the end of March, we have actually seen current delinquency rates have dropped for January—or excuse me—for February and March, we saw delinquency rates drop fairly significantly, 15 percent, over where they were in December. So while we are seeing delinquency rates drop, we are seeing foreclosures, actual, real foreclosures increase. And so what we expect to have occur for the year is 125,000 foreclosures with an expected severity rate on each of those losses of somewhere in the range of 50 percent. And so, the specific losses to the fund at year end—and George, I do not know if you know the number that is in the MMI.

SPEAKER. No, but like you said earlier, the capital resources have been increasing.

Mr. STEVENS. Yes. I mean, the reality is our capital resources have been increasing. So let me step back. We reserve very differently than a bank does. A bank under a Basel standard will hold for loan loss reserves for anywhere from 2—sometimes 1 year to a

3-year period they will hold for loan loss reserves. So the FHA's reserves function is we hold capital in reserves for a full 30 years' worth of losses. Much of that loss expectancy will not hit until peak default periods, 2, 3, 4, or 5 years into the amortization of a mortgage.

So when we reported that we were below our 2 percent capital reserve, it was not our total capital, Senator. It was our secondary loss reserve, which is an additional loss reserve above our primary reserve account. And the two combined reserve accounts are actually in excess of about 4.5 percent of total capital. The 2 percent reserve requirement is based on the secondary account, which contributes to that. That is what had fallen below 2 percent, but our primary reserve account actually continues to grow simply because we are not seeing the losses that were fully expected when the actuarial audit was done.

So without trying to sound evasive, the reality is that we are not seeing the real losses as yet. Our actual reserves are growing. The forecast is that under the existing book of business, we will exhaust the entire amount down to that remaining capital reserve of .53 percent. That forecast assumed that we do not originate any new loans. So as we continue to originate new loans of such high quality, the fund is actually rebuilding faster with better assets offsetting that loss reserve.

Senator BOND. Have you got a number? How many billions will you experience in loss this year?

Mr. STEVENS. In this year?

Senator BOND. You must have some forecast.

Mr. STEVENS. Do we have a forecast, George?

SPEAKER. We are not forecasting.

Mr. STEVENS. Yes. So we forecast the reserve number. We do not forecast this current year number. But, Senator, if it would be all right, I would like to give you a more thoughtful answer.

Senator BOND. Yes, we would like to know because we need to get a handle on this somewhere. We have got reserve accounts and reserve accounts are growing, but losses are out there. There is no question that there are losses out there, and we need to have a handle on where all this is going.

Mr. STEVENS. Senator, if I may, I would tell you that we would expect by year end that the fund would be either about where it is now or higher. The actual reserves will be about where they are now. What it will impact, unfortunately, from a budget standpoint will not be our actual losses. It will be what is forecasted in what we have to reserve against. So those will be very different numbers in terms of how we look at it. But I will submit to you a more thoughtful response to that question.

Senator BOND. Okay. You mentioned that you are still confident in the official $5.8 billion estimate or whatever it was that OMB came up with. CBO came in with a $1.9 billion in receipts. What is the difference? How do we resolve this? We are kind of looking at hither and yon, but we need to have where we are rather than hither and yon.

Mr. STEVENS. So the challenge is both analyses are based on views on various performance characteristics. The difference in the CBO score, in particular, can be mostly isolated into two variables.

One is they assumed much higher prepayment speeds on our portfolio than was in the OMB estimate. Interestingly, prepayment speeds are a derivative of interest rates. If interest rates drop dramatically, you get much higher refinancing and loans will pay off earlier. If interest rates remain stable or rise, you would actually expect prepayment speeds to be slower. And so depending on that forecast, you are going to have an impact to prepayment speeds, that combined with default rates.

So that is one variable that is very different, and I would question the prepayment speed assumptions, but I am sure they are based on rational logic.

The other one is the severity rate. So on your losses, you know, what is going to be percent of loss on each actual unit of real estate that goes into foreclosure. And the CBO score expects higher severity rates than the OMB score does. In that particular measure, I would say there is probably a little truth to both, and we will look at that very closely.

But it is interesting that the prepayment speed issue—if you assume you are going to have losses and worse severities over the long term, you would assume that the market is worsening. My own internal logic would say that if interest rates are dropping, you are probably going to have increasing volumes of new home sales which may actually level or spur recovery.

So while there may be some natural conflict there, I think both are based on rational input. Both expect positive receipts from FHA in either case. The amount differs because of those two variables.

Senator BOND. You said in your first element was the prepayment, and that if interest rates go down, prepayment goes up. So you get better returns. But I do not see how, with the problems we have, which are too much like Greece's problems with our debt with an unending series of spending and declining tax revenues, somewhere those interest rates are going to go up. And I do not see—even though the Federal Reserve has been accommodative, perhaps overly accommodative, I do not see any prospect that interest rates are going to get lower. Are you predicting lower interest rates rather than higher?

Mr. STEVENS. I am not predicting lower interest rates. I think we would have to ask the CBO what variables they assumed for faster prepayment speeds on our portfolio than the OMB view was, or quite frankly, our own independent actuary had as well similar prepayment speeds to OMB.

Senator BOND. I tell you what. We probably are not going to hash this out.

Mr. STEVENS. Yes.

Senator BOND. I have got a staff that loves to get into those things, and maybe they can work with your staff and we can see if we can find some way to resolve those. And we will ask the inspector general and your actuary and everybody to get together and have a whole lot of fun working those things out.

Mr. STEVENS. That sounds great.

Senator BOND. If you do not mind.

Mr. STEVENS. That is wonderful.

FINANCIAL REFORM

Senator BOND. Now, while we are asking easy questions, as you have indicated and the chair has indicated, as you know, we are debating a financial regulation bill on the floor, and from what I have learned—and granted, some of it comes from the book, The Big Short—the problem of shaky subprime mortgages was exacerbated in Wall Street by creating mirror derivatives based on the subprime securitized mortgages. And these—I call them computer game shadow derivatives—magnified the impact. In other words, Wall Street was making a whole bunch of money on derivatives that mirrored the subprime but these were not actually based on the subprime loans themselves. But when the subprime loans went down, all of the value of those derivatives, which for some reason were successfully marketed to people who were willing to go out on a limb—is that an accurate assessment of what happened in the financial system?

What kind of regulation would be necessary to rein in the risk that the excessive Wall Street manipulation of derivatives will not impose in the future the same kind of serious risks to the financial marketplace we have seen not just in America, but we managed to poison a lot of the world's economic systems?

Mr. STEVENS. Which question was easier, this one or the last one?

Here is just a view that I would articulate, that the financial reform bill is critical. The risk retention component, just as one example, clearly under any of the amendments that are being offered, would require risk retention for those kinds of programs. Looking back at how these products were created and manufactured and being in the private sector and watching that occur, there was clearly a lack of alignment on incentives, short-term gain based on models that were not tested, and there was no recourse or skin in the game for that creation.

I think to that end, whatever ultimately comes of the amendments on sort of vanilla programs or things offered by the Landrieu amendment or some of the other amendments that have been offered, I think one of the most critical values that will come of financial reform, if it gets passed, which I strongly encourage, is that without question, no one is carving out the products that you address. I think to that end, having to hold capital against loss is clearly—and you made that point about capital reserves that we are requiring at an institutional level. In my opinion, capital reserves on risk assets, putting a risk-based weighting against those, is the clearest way to require that skin in the game and interest in making sure that your evaluations of risk are appropriate to the real risks that you ultimately see.

Senator BOND. I have run over my time.

But the SEC has now come in full force in going after these. But it is my understanding that they or—I think they are the ones that should have been regulating these. And I heard a great Texas country band called Asleep at the Wheel recently and I was thinking about how that might be a good moniker for what went on in the regulatory agencies. Is the regulation of risk an SEC function? What agency should be doing this?

Mr. STEVENS. Without going back to the past and the multiple regulators——

Senator BOND. Okay. Going forward, who ought to——

Mr. STEVENS. Going forward, one of the things that I think is also important about the financial reform bill is the creation of a CFPA, having a single regulator to oversee mortgage products that are directed to consumers. You know, I think to some degree you have articulated a very important point. When you have multiple regulators, specific ownership of specific risk attributes may become murky. And I am not sure that is the case in the past. I have personal opinions, but I know that Secretary Donovan and Secretary Geithner would have clear statements to that effect. But I would say that that is another value proposition in the financial reform bill to get this through, is to identify a single regulator responsible for regulating mortgage products.

Senator BOND. Thank you, Madam Chair.

MAKING HOME AFFORDABLE PROGRAM

Senator MURRAY. Thank you. Thank you very much.

About a year ago, the administration launched their Making Home Affordable to help homeowners with foreclosure. One of the programs is this HAMP, Home Affordable Modification Program, was designed to make mortgages more affordable, lower interest rates, spread mortgages out, now by writing down principal. We were told that that program was supposed to help 3 million to 4 million families by 2012, but as of the end of March, only about 230,000 homeowners had received any kind of permanent modification, which is far short, I think, of expectations.

Can you tell us at what rate do we need to see permanent modifications occur in order to reach that 3 million to 4 million goal?

Mr. STEVENS. So if I may, I would just like to back up to the initial program and kind of where we are today. When the program was first rolled out, we all know that adoption was slow in the program. Bank readiness to manage the HAMP program was not developed at a pace that was acceptable to the administration.

In July of last year, both Secretaries Geithner and Donovan, asked in what became the infamous fly-in where all the CEOs of the banks involved in HAMP flew into Washington, and a lot of pressure was put on to get the program up and going and the announcement of the scorecard at that point.

From July until the end of the year, there was a rapid ramp-up in trial modifications. Unfortunately, a lot of the initial modifications done by some of the institutions were modifications first without getting the appropriate documentation to ensure that they would be sustainable into permanent mods.

And so what we may see is a relatively higher cancellation rate of that initial population.

Since then, through a learned process, we have transitioned to where documentation and qualification is now going to be done upfront at the trial modification period, and we believe that there will be a high transition from trial to permanent mod on all mods going forward.

So I just wanted to put that out there. We just this week had another fly-in with the executives of all the institutions in HAMP and reiterated and went through the details of the new process. I left with the feeling of confidence that at least that portion is done. We will not have that high fallout.

I would say that we still have well over a million homeowners saving $500 a month in trial modifications, of which, to your point, the 230,000 have converted to permanent mods. We have 108,000 more that have accepted a permanent mod and are waiting to sign documents. You will see some rapid activity over the next 60 days because the institutions all involved in HAMP have pledged to clear out their pipelines of backlogs from that initial phase over the next couple of months. So we will see a big transition there.

Senator MURRAY. So by the end of the summer, we will see better numbers?

Mr. STEVENS. I think we will see some interesting numbers for the next couple of months, as we see the backlog of nonpermanent modifications either go permanent or go into portfolio modifications that are not part of HAMP or perhaps pure cancellation. So there will be some noise there as they clean out the pipelines.

We will then see, I believe, a regaining of activity on trials and permanence. That, combined with our enhancements to HAMP, which we just recently announced and the FHA program we believe will remain on track to hit the 3 million to 4 million homeowners that the administration committed to by 2012.

Senator MURRAY. All right.

At home I am hearing from a lot of counselors and homeowners about the problems that they are facing in getting permanent mortgage modifications. It is very frustrating. In fact, it is actually anger, especially when we hear about the profits that a lot of these banks are making in large part due to Federal taxpayer assistance. Since a lot of these banks have received direct or indirect Government assistance, is there anything the administration is doing to make sure that they are working in good faith now to assist these troubled homeowners?

Mr. STEVENS. There are several things that have occurred and I would be eager to follow up with either of your offices with additional information, but let me just say a couple of things.

One is, I think you are all aware we have the Making Home Affordable Web site. We also have the Making Home Affordable hotline where consumers can call in, if they are not getting the response they think they need from their banks, and we have teams that will triage those and respond to them fairly quickly. So they do have a direct, non-institution channel if the point of frustration comes. So that is a backstop at the point where they are probably already frustrated.

On the front end, that was one of the——

Senator MURRAY. My front desk in my Seattle office would tell you that that is not working very well.

Mr. STEVENS. The hotline is not working?

Senator MURRAY. Yes.

Mr. STEVENS. Okay, that is good feedback. I would love to hear more about that. We actually talked about that in our meeting this week.

You know, the other issue that has gone on with the HAMP program is the banks did not staff up. People would call initially. They could not get someone on the phone. They would send in packages. We have heard stories of lost documents. We have done several things to try to address that environment.

Senator MURRAY. Banks not returning phone calls forever.

Mr. STEVENS. That is right. And I get a lot of personal e-mails and phone calls from just consumers that I have to get involved with, just as I am sure your offices do, and their frustration level is very high.

There are several things we are working on in the banks. One, from a readiness standpoint, they are clearly better off today than they were even 60 days ago. So we are hopeful that will happen; that they are onboard. We have made them all designate a czar or a head of the HAMP program within their institutions that is solely accountable for HAMP and has the authority to make decisions around HAMP. That was a directive of the meeting this week.

Senator MURRAY. Will we know who those people are so we can direct our constituents to them?

Mr. STEVENS. I will work with that office, and we will try to make sure that list is made public for you.

Senator MURRAY. If it is just one more phone number that they call that they cannot get to, it is not going to be very helpful.

Mr. STEVENS. Right, I recognize that.

This is a directive. So we have asked them to identify that individual, make it clear. We want to assemble who the head of that is, and we are going to have a much increased frequency of meetings between the Treasury Department and HUD to meet with these heads for all the institutions to make sure they are staying onboard with the HAMP process.

We have changed documentation standards. We have done field checks. We have gone out and done individual field visits with each of the institutions to investigate their process. We are sharing best practices.

But without question, the frustration is real. The lack of activity and readiness was absolutely there. They were not ready. They continue to get ramped up and onboard from an operational standpoint. And then there are a lot of issues in just getting access to the homeowners, having them understand the paperwork involved from the trial modification to transition to the permanent modification.

So all of these are real challenges, Phyllis Caldwell, who is heading up the office for Treasury, is a great resource and is very focused on it on a full-time basis solely on HAMP to try to make sure that these problems are resolved, but without question, I mean, quite frankly this was a huge program that was implemented. It has never been done before. The banks did not get ready quick enough. We have all collectively learned about what was not working through the process. I think a lot of——

Senator MURRAY. Well, I guess from my point of view, I want to know that the banks are working to do this rather than doing everything they can to make it not work or stall it or not get involved.

Mr. STEVENS. We agree, and we made that point. I can assure you that the meeting that was held this week, which was attended by mostly CEO levels of all the major lenders—Assistant Secretary

Herb Allison was very direct on that subject, as were all of us at the table about their needing to be ready to stop these customer responses, these consumer responses that are so frustrated. And I have personally spoken to them myself as well, and I feel without question their frustration and pain. They have committed to going there. They all acknowledge there are still going to be some missed—just because of the vast number of people, but we need to do as much as we can to eliminate that frustration.

If it would be okay, I would actually like to have Phyllis Caldwell draft a response for you on this question——

Senator MURRAY. I would really like that.

Mr. STEVENS [continuing]. To lay out with specificity what is going on so that if there are questions or concerns you have from there, we can respond further.

Senator MURRAY. Okay, and to give her our feedback that this is a huge frustration for a lot of our constituents right now.

Mr. STEVENS. Yes. And she knows it and we have had meetings with many Senators and Members of the House on this issue. We all get it. We all know the score now, and the pressure has to be on these banks to get ready to view this as the same priority as they would originating a new loan through their sales force. They have pledged their commitment. They re-pledged it at a meeting that we made them fly in for this week. It was a very stern discussion on the subject. So we share your concern. We share the frustration, and it is a full court press from both Secretary Donovan and Secretary Geithner.

Senator MURRAY. It may take more than being stern.

Mr. STEVENS. It might.

Senator MURRAY. Also in my last few seconds of my time, there is an FHA HAMP program which applies only to FHA mortgages, and that is the one you have just been talking about. Okay.

And if you want to, please comment on that, and I will turn it over to Senator Bond.

Mr. STEVENS. Yes. The HAMP program I was referring to was not FHA. It was the broader HAMP program, but that does include the FHA numbers. The FHA HAMP numbers are actually very small. They are in the low thousands, and I think the reason for that is FHA has a loss mitigation program that has been so successful and has been in the market for many, many years. We have just a greater experience with dealing with loss mitigation, and to that extent, we have addressed over 600,000 in-distress homeowners in the last year on our own outside of HAMP. And I would be glad to report the resolution numbers on those, if you have interest.

Senator MURRAY. That would be good.

Mr. STEVENS. Okay.

Senator MURRAY. Thank you.

Senator Bond.

Senator BOND. Thank you, Madam Chair. That was an area that I wanted to explore, and you have done that, and we thank you very much, Commissioner, for your comments on it.

Let me ask in a related area. It is my understanding Freddie Mac was directed to buy back troubled loans from investors, taking the losses on the mortgage. It seemed to me that that policy was designed to bail out lenders on their risky investments but did little to save a home with a risky loan for the homeowner. Am I missing something here? You want to keep the investors happy, but if they are losing their skin in the game, should we be bailing them out?

Mr. STEVENS. I apologize. I do not have the specifics on that. I will tell you that in meetings with Freddie Mac and Fannie Mae, which we have had, this week, the vast majority of their efforts are not there. The vast majority of their efforts are in working on the HAMP initiatives and modification and HAFA, the refinance program, and very little on the buybacks. I could guess, but I would rather not guess for you and get specifics back on what assets they bought. I do not know the size of it.

HUD INSPECTOR GENERAL EFFORTS ON FRAUD AND ABUSE

Senator BOND. We are interested in getting a handle on this because, as you have indicated, there are so many moving parts in this that we want to try to get a handle on as many as possible.

We talked about the fraud and abuse efforts. Is there a joint oversight program with Justice, Treasury, HUD inspector general, and other agencies? You talked about 365 cases have been referred to the Mortgage Review board. Do you know how many of those cases have—question No. 1, is there a joint effort? Question No. 2, how many criminal indictments? Do you know offhand?

Mr. STEVENS. Senator, I would probably defer to the inspector general who is playing a huge leadership role in the fraud joint task force. So I would encourage——

Senator BOND. Maybe we could invite Mr. Donohue to come to the table, if you do not mind, just briefly on this one.

Mr. DONOHUE. First off, may I thank you very much. I would be remiss, Senator, if I did not respond back to your first comments. I am so grateful to you for your support. I would be remiss in not mentioning Senator Mikulski and Senator Sarbanes and Senator Murray as well and John Kamarck of your staff and Megan from yours, Senator Murray.

This is not possible. You mentioned seller down payment assistance. I think if seller down payment continued, we would be having a different discussion here today. It is a result of your leadership that that is possible in support of that effort.

We are very heavily engaged with the Department of Justice. We are involved in a major Federal fraud task force that I sit in with Attorney General Holder and his deputy staff. We had three summits recently: one in Miami, one in Detroit, and one in Phoenix, Arizona. And we had a chance to have people come in from the industry, people who are victims and talk about some of their concerns and also the law enforcement community as well.

The reason I mention that, getting back to Senator Murray's concern, you were talking about the counseling which is very important to you. One of the things I do want to mention to you when you spoke to that is what we are finding and the concern to us is that we are finding fraudulent counseling going on——

Senator BOND. Oh, really.

Mr. DONOHUE [continuing]. Where people are going back out and being contacted and being approached to give certain fees of sorts.

And of course, that person disappears in the night or continues on the fraudulent activity. That came out in all those three summits very actively. So it is not just the challenge of—the statements that the Commissioner made, but also we are seeing a significant amount of fraudulent activity as well.

As far as our cases are concerned, we have about 2,400 civil investigations on right now with regard to cases specific to the FHA fraud activity. We have created a civil fraud initiative. And you mentioned about the other agencies working together. I was on the National Bank Fraud Working Group back in the RTC days. And I think what we are seeing now is a collaboration of law enforcement working together.

I think it is a great challenge, sir. I think that these regulatory agencies talking to each other, working with them collectively—I have spoken to the Commissioner about setting up a consortium with Fannie and Freddie and the other GSEs. The best practice. I would like to see standard forms applying with regard to this mortgage activity. I have spoken to that in my testimony.

So we are very active. We are working well with regard to law enforcement agencies and, like yourself I share the same sentiment. I would like to see a lot more people in orange or red suits as much as I could on these cases.

Senator BOND. I know by the fall of 2008, I was following very closely my home area. The Eastern District of Missouri U.S. Attorney had initiated three major actions with numerous parties involved. I have not had any follow-up or heard how many criminal prosecutions related to mortgage fraud. I do not know if they were all FHA—have been initiated, how many have been concluded with a successful conviction. Do you know that?

Mr. DONOHUE. Well, sir, my semi-annual report I was just given, indictments and information from the period of April 1, 2009 to September 30, 2009, 1,182 indictments and information; convictions, pleas, pretrial diversions, 847.

Senator BOND. Good. That number needs to be publicized because that is the greatest prophylactic to let people know if they are going to do it.

I was concerned to hear your comments about fraudulent counseling. A few years ago, Senator Dodd and I created a $180 million foreclosure counseling effort. I talked with people all over my State who were involved in the counseling, and they were having some success, minimal success. But the one thing they emphasized to me was foreclosure counseling is not good enough. There has got to be pre-purchase counseling before somebody buys a home. We have to have an independent and maybe not a fee-based counseling program set up to sit down with the family, potential home buyer, explain to them what their obligations are, and look at their finances to see if they can buy a home.

Commissioner, obviously you have got some thoughts on that.

Mr. STEVENS. Yes. We share the concern. In fact, I have been hosting meetings with industry participants to talk about financial counseling particularly related to managing personal finances and mortgage finances before you make the decision to buy a home. We have had the help of members of the Housing Policy Council and others come in and show us and make recommendations of how we might go down that path. It is very complicated to institute a whole new way of doing pre-purchase financial counseling as opposed to what most housing counselors are doing today, to your point. Given the huge volume of foreclosures in the market, most housing counselors are overwhelmed with homeowners in distress. So the ability to transition into being able to have the time and scope to do pre-purchase sort of financial literacy becomes more challenging.

The other thing is most of the agencies in Washington that deal anywhere in the financial area have some sort of financial literacy classes that are available on their Web site, and so there is some opportunity to consolidate those together. But we are working on that right now and hopefully will be able to report back on that sometime in the future.

Senator BOND. Well, thank you. I think that is very important. Senator Murray and I are concerned a whole lot about what happens in Washington State and Missouri. And the people on the ground are the ones who really need to do it. In our State, NeighborWorks has been a very good partner. And we look forward to seeing those efforts expand and perhaps more assistance is needed in that pre-purchase counseling.

Mr. Donohue, I am disturbed to hear that there are fraudulent counselors. But again, the best place for them is in Government-restricted housing. I wish you the best in assuring their placement in that kind of facility.

Mr. STEVENS. It is interesting. The President even spoke about this when he first came into office. But if you watch TV and see someone helping someone walk away from their home, I think that was one of the things covered on the recent piece on strategic defaults. They called themselves counselors. They charge a couple $1,000 to counsel a family in distress, and they are not authorized. Free counseling is available, and getting that information to distressed homeowners is the big challenge.

GSE LOSSES

Senator BOND. One quick question. I do not know if you have the answer to this. On the GSEs, do you know how much of the losses are coming from their old books of business as opposed to the new business like foreclosure mitigation efforts like HAMP?

Mr. STEVENS. I recently just looked at some of their performance data, and Senator, like with the FHA portfolio the vast majority of these losses are on older books, 2006, 2007, and 2008 are just terrible portfolios. They are bad for FHA and they are bad for Freddie and Fannie. And it is those portfolios that we are going to be all experiencing losses on and paying the price for several years more to come.

Senator BOND. Thank you very much. I hope that the new business does not catch up with the old business. Thank you very much.

I have a commitment I have got to make, but I appreciate very much your testimony. We have got a lot of interesting follow-up that we are going to ask the staff to do.

Thank you, Madam Chair.

Senator MURRAY. Thank you very much, Senator Bond. And I would just say I have a financial literacy bill that we start teaching basic financial skills back in our elementary schools. You and I probably are the few here who remember our banking Fridays at school where we learned how to balance our checkbooks and how to read basic financial statements and that is lacking in education today.

Senator BOND. The only thing I would add, I took a very high-level law school course on banking and bankruptcy. And I was having trouble with my checkbook, and the instructor said my checkbook never works out right. So I always take the bank's view from it.

HAMP

Senator MURRAY. A prevalent opinion today.

Moving on, thank you very much, Senator Bond.

I wanted to go back for a second to the HAMP program. Originally it was focused on reducing interest payments and spreading mortgages. The administration has changed that, focusing on principal write-downs and relief for unemployed borrowers and an expansion of the existing refinance program.

In order to participate now, lenders are required to write down principal and make sure that a borrower's mortgage is affordable, as measured by total mortgage debt, including both their first and second liens. As I talked about in my opening statement, these mortgages do come with additional risk, and $14 billion in TARP funding has been set aside for that initiative.

Commissioner Stevens, how much additional risk do you expect to find these refinanced mortgages to carry?

Mr. STEVENS. Senator, the way we are looking at the program is the allocation of the $14 billion in TARP funds will be to cover the incremental risk exposure on these loans. While we have modeled various paths of the loans that come in, the variability will be on seeing the actual loans as they are originated. So, for example, as you are aware, we allow a combined loan-to-value where a second lien holder can subordinate up to 115 percent. It is estimated that one-half of all negative equity loans in America have a second lien, but we do not know how many of those will come into the FHA portfolio. Those that have subordinated second liens are going to have a higher risk weighting on our portfolio, as we see them come in, than those that do not.

Likewise, the FICO score distribution can have a wider range, and if the FICO distribution ends up being much lower on the scale, they will have a higher risk weighting than those that do not.

So we have the $14 billion allocation from Treasury. We do not, but that will be assigned to offset the claims from the lenders. As the loan comes in, we will be evaluating that volume coming in. If it skews off the path, we have the ability in the program, as announced, to stop it with little notice. And our Chief Risk Officer, Bob Ryan, is tasked with managing that overview. We will have the data of all the loans coming in as they are being insured. So we will just watch the volume coming in, the distribution of all those attributes that can cause risk, what risk rating we assign to those, and we will stop the program at a point in time if the risk seems greater than what we originally foresaw.

DEFAULT RATE

Senator MURRAY. What is the default rate that you are assuming?

Mr. STEVENS. Without giving specificity—and the reason why I am trying to avoid is there is a wide range of default expectations. There is a high default rate, which would be something similar to what we are seeing on some of our worst books of business from the past years. There are some estimates by some economists who think this is actually going to be a better performing book than even a standard refinance because the borrower incentives to come into the portfolio are that much higher. So to that extent, we know we have a bucket of risk mitigation dollars from TARP that will be available to the lenders to pay their claims, and that is why it is important to watch what comes in because the distribution could be from very low to very high.

It is kind of like stochastic modeling where you are looking at a variety of outcomes. We just know that we are going to use those real loans coming in to identify what path they are coming in on, and that will help us forecast as to when the funds will be exhausted.

Senator MURRAY. How much of the $14 billion will actually cover the costs that are expected to result from additional risk and how much will be used to provide incentives to lenders or help extinguish second liens?

Mr. STEVENS. The only incentives that are being provided at all are incentives for second lien extinguishment. There are no servicer incentives provided in the FHA solution, and there are no first lien principal write-down incentives whatsoever. So the private sector will bear all the costs of writing down the principal balance and refinancing that mortgage into a new FHA mortgage. So the only variable on the $14 billion will be the second lien, and without again trying to be evasive, because of the various paths and what our expectancy is on how many of these will have second liens versus those that will not, we have a wide range. I would say for a simplistic view, we expect the second lien extinguishment portion to be a relatively small percentage of the $14 billion because it only pays pennies on the dollar anyway, and the vast majority of the $14 billion will be to offset risk to the FHA portfolio.

We have pledged to report these numbers and share them with a high level of frequency with the Department of the Treasury. We are both going to be reviewing the actual assets coming in carefully together because our primary focus is not to add incremental risk to the FHA portfolio through this initiative.

STRATEGIC DEFAULTS

Senator MURRAY. In my opening remarks, I mentioned the concern I have about strategic defaults, people who are defaulting because they are just making that decision to do it not because they are personally not able to make their mortgage payment. I am concerned that this could provide some serious instability in the market, and I wanted to ask you, is there any good data today on how serious this problem is or something that you are seeing with FHA-insured mortgages?

Mr. STEVENS. We have done a great deal of research into the strategic default area. There is no history on this. Strategic default is a new anomaly for this recession. And as I am sure you are concerned and I am concerned—I was interviewed on 60 Minutes on Sunday on this subject. There is a significant moral hazard that will pervade the mortgage finance system for decades to come should this become a real problem.

Based on estimates we have gotten from independent third party analysts which include the GSEs' view as well as economists like Mark Zandi, it is estimated that real strategic default risk is in the single digits as a percentage of overall foreclosures. So somewhere between 7 and 9 percent are sort of the current estimates of what are real strategic defaults.

Now, the issue ends up being that negative equity is highly concentrated in five key States, the sand States plus Michigan. And in those States—in Nevada, which is the worst hit, for example, if you look at all negative equity loans, which is somewhere between 11 million and 15 million loans that have negative equity, about one-half of those are either second homes or investor properties, and some small percentage of those are also super-jumbo, million-plus dollar homes. So when you isolate back down to the rest of the borrowers that have negative equity, you break that down into two categories. The greatest category will be those—our default risk will be those that are in distress that have lost their jobs, had income curtailment.

Laurie Goodman of Amherst Securities suggests that negative equity could contribute 1 percent to the unemployment rate because people just cannot accept a job somewhere else because they cannot get out of their home without going into foreclosure. That is where the focus of our efforts is.

But our solution with FHA does allow an investor, if they think a strategic defaulter is going to walk away, to write down their principal too and put them into a refinance, if they will stay. But we do need to track this carefully over time and see, to the extent this becomes a greater hazard because the ramifications, as I am sure you would agree, go far beyond just the foreclosure risk to those communities. It will affect how loans are priced in the future if that is considered a real risk.

Senator MURRAY. And the other question I wanted to ask you about is the so-called shadow inventory. We obviously have an oversupply of housing right now, and there is a concern that with all the newer imminent foreclosures that are coming or banks that are holding repossessed homes if those start flooding back on the market, what kind of impact that would have. Could you talk a little bit about how big perhaps the shadow inventory——

Mr. STEVENS. Again, this is another where there is great research on it. In fact, I have a couple of good studies I would be glad to send to Megan or however you want me to get it back to you that have been done independently.

The shadow inventory is real. And the in-foreclosure numbers are clearly higher than the actual foreclosure numbers. I know that in the FHA portfolio and I see it in the numbers at both of the GSEs. So there are a lot of reasons why that has been built up, part of which is just the overwhelming volume that hit many of these counties that have to process foreclosures, moratoriums placed in various States or areas where the courts put a freeze or bans on foreclosures for a period of time. Clearly the loss mitigation efforts by FHA through HAMP, even portfolio modifications have also slowed the process down, and banks are obviously being much more aggressive to try to delay the foreclosure if they can find any way to work out a borrower's situation in most cases. And so the inventory of in-default is clearly rising.

Now, there are some estimates that based on some home price appreciation forecasts, even modest ones, that a good percentage of those foreclosure problem cases could be resolved just by some slight improvements to unemployment and some slight improvements to home values, in other words, that they are close enough to the line that they could back into an affordability with some involvement on either forbearance or modification efforts that are being done today.

But it is still—without question, the numbers are large. At FHA, for example, our in-foreclosure numbers are about double what they were a year ago in foreclosure, but our actual foreclosures are not double of what they were a year ago. That is why, even though we are behind on actual foreclosures today based on our forecasts, I expect them to rise based on what I am seeing in this shadow inventory that is coming in.

So we are looking at the data very carefully. And again, I would be glad to share at least some independent looks that I may have available with your office.

Senator MURRAY. I would really appreciate that very much.

With that, I want to thank both of you, especially Commissioner Stevens, for your input today. It has been very valuable.

ADDITIONAL COMMITTEE QUESTIONS

There will be questions submitted by a number of our subcommittee members. We will leave the record open in order to have you respond to those.

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

QUESTIONS SUBMITTED BY SENATOR PATTY MURRAY

FHA RISKS

Question. As we have discussed, CBO recently came out with its re-estimate of the receipts that FHA will generate from mortgages insured in fiscal year 2011. The result is a loss of $4 billion in anticipated receipts. This is not the first time that CBO had disagreed with OMB's assumptions for receipts. Do the current models appropriately account for risk?

Answer. FHA spends a great deal of time and effort studying the credit risk of its insured portfolios. The valuation models used for the single family insured portfolio have been developed over a 20-year period and capture all of the essential factors needed to value a national portfolio. Those include borrower credit quality, downpayment rates, house price changes, and interest rate movements.

For its scoring of the fiscal year 2011 budget, the CBO did not have a similar credit risk model for FHA. They are in the process of building such a model for scoring the fiscal year 2012 budget. CBO also, but not unlike OMB, prefers to err on the side of conservative judgments, especially when there is uncertainly involved. The nature of any disagreements on the value of FHA loan guarantees generally comes down to uncertainty with respect to future housing market conditions. There is no right answer. There are only informed judgments, and persons of goodwill can differ markedly in their preference for some risk-adjustment factor in forecasting.

The direct impact of larger economic risk adjustments in a budget forecast is to lessen the expected budget receipts generated from the FHA insurance programs, and thus lower the overall receipts the Congress has when formulating a budget. The indirect impact is to increase the probability that, in future years, there will be beneficial budget re-estimates for the affected cohorts of loan guarantees, and lessen the probability of adverse re-estimates.

FHA PRIORITIES FOR INVESTMENTS

Question. As I mentioned in my statement, improving the information systems at FHA are critical. As you know from coming from the private sector, the systems at FHA are outdated and are in some instances opening FHA to unnecessary risk. Last year, we provided HUD with significant resources to invest in IT systems. This included funding for immediate fraud detection and mortgage fraud tools as well as longer-term investments. How are you prioritizing these IT investments?

Answer. With respect to prioritization for Combating Mortgage Fraud, fiscal year 2010 funds are being used to address a broad range of risk and fraud management efforts within the Department. FHA has worked diligently to put in place contract vehicles which provide access to industry leading tools and professional services that will greatly enhance the Department's capabilities related to fraud detection/prevention and risk mitigation. Specifically, we are focused on the following three functional areas:

—Counterparty Risk Management Functionality

—Analytical Consulting Services for risk and fraud tool evaluation and selection

—Consulting and Contracting Services for Loan-level File Review

Through the acquisition process, HUD has focused on services that address the most critical and immediate areas of need within FHA to reduce the likelihood of insuring fraudulent and high risk loans, detect trouble spots among product types, improve targeting methodology for loans selected for review, significantly improve counterparty due diligence and review, and aggregate key information to make informed and reasoned decisions across the organization. To the extent feasible, these services are designed to have applicability across the FHA enterprise and may well reduce total organization contract expenditures on duplicative tools and services. However, the short-term application of this contract vehicle will be for the Single Family portfolio with downstream usage envisioned for multifamily and hospital financing.

With respect to prioritization for longer-term FHA IT investments, the use of the Transformation Initiative funds for IT purposes requires detailed IT planning per Congressional requirements. Our modernization objectives align with the FHA IT Strategy and Improvement Plan (FHA IT Plan) submitted to Congressional committees in August 2009. As articulated in the FHA IT Plan, with many, if not all, of Housing's IT systems being old and outdated, our priority is to transform and upgrade FHA's infrastructure in line with modern financial services organizations. This initiative is being designed and planned to leverage the specific components of the Risk and Fraud initiative as they become a reality for FHA. This is how all of the Transformation work comes together. Tools selected through the Combating Mortgage Fraud Initiative will fit into the portions of the architecture that house aggregated capabilities for FHA. In addition, counterparty level information, required by the Risk and Fraud initiative, will flow into the front end of the FHA Infrastructure data area and provide valuable insight throughout the insurance lifecycle.

Question. How quickly do you think you can make these IT upgrades?

Answer. FHA has worked closely with internal (e.g., OCIO) and external (e.g., GAO, OMB) organizations to create measurable 6-, 12-, and 18-month deliverables for the FHA Transformation work. While our project planning materials indicate that this initiative will be a multiyear effort that spans longer than an 18-month timeframe, the initiative has been crafted to ensure that measurable value is delivered in as short a timeframe as possible.

NEW SHORT SALE PROGRAM

Question. In the midst of all of the attempts being made to keep families in their homes, the administration recently announced its plans to implement a program to facilitate short sales. Through these sales, lenders and borrowers consent to take a loss by selling a home below the mortgage balance owed in order to avoid foreclosure. How much would this initiative cost?

Answer. As this is an initiative led by the Department of the Treasury, it would be more appropriate that these questions be directed to that agency for response.

Question. As with all of the housing programs, this would be a voluntary program, and lenders already have the ability to do short sales. Why do you believe that the relatively modest amount of incentive payment that would be offered will be enough to increase the number short-sales so that it has a real impact on the housing market?

Answer. As this is an initiative led by the Department of the Treasury, it would be more appropriate if this question was directed to them for response.

Question. Under this new program, participating owners would be required to sell their home if an offer is made at a pre-determined price. Under the proposal, this price would be determined by Real Estate agents. Given the inherent subjectivity of home value determinations, there is a concern that this program could be open to fraud and conflicts of interest. What protections will be put in place to mitigate these risks?

Answer. As this is an initiative led by the Department of the Treasury, it would be more appropriate if this question was directed to them for response.

HOME AFFORDABLE MODIFICATION PROGRAM

Question. One of the problems with HAMP has been the capacity of servicers to process the claims. Do you think that servicers have the capacity to manage a significant increase in short sales?

Answer. As this is an initiative led by the Department of the Treasury, it would be more appropriate if this question was directed to them for response.

SUBCOMMITTEE RECESS

Senator MURRAY. Again, thank you so much, both of you, for your participation today.

With that, this hearing is recessed, and this subcommittee will hold its next hearing on Wednesday, May 19 at 3:30 on the fiscal year 2011 budget request for the Washington Metropolitan Area Transit Authority.

[Whereupon, at 11:09 a.m., Thursday, May 13, the subcommittee was recessed, to reconvene at 3:30 p.m., Wednesday, May 19.]