TRANSPORTATION AND HOUSING AND URBAN DEVELOPMENT, AND RELATED AGENCIES APPROPRIATIONS FOR FISCAL YEAR 2014

TUESDAY, JUNE 4, 2013

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

The subcommittee met at 2:30 p.m., in room SD–138, Dirksen Senate Office Building, Hon. Patty Murray (chairman) presiding.

Present: Senators Murray, Collins, and Boozman.

DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

STATEMENTS OF:

HON. CAROL GALANTE, COMMISSIONER AND ASSISTANT SECRETARY FOR HOUSING, FEDERAL HOUSING ADMINISTRATION

HON. DAVID A. MONTOYA, INSPECTOR GENERAL, OFFICE OF INSPECTOR GENERAL

OPENING STATEMENT OF SENATOR PATTY MURRAY

Senator MURRAY. The subcommittee will come to order. Senator Collins will be here in just a few minutes, but we'll go ahead and get started.

But before we do begin, I do want to just take a moment to remember Senator Frank Lautenberg. He was a passionate public servant who wasn't afraid to fight for what he believed in. It goes without saying he was a wonderful member of this subcommittee, and he was actually former chairman of this subcommittee and added a really important voice to many of our housing and transportation issues. He was a tireless advocate for his State and for policies that protected Americans.

He fought hard to make sure we funded Amtrak and banned smoking on airlines and raised the drunk driving standard. We owe him a tremendous debt. So I just wanted to start today by remembering him and letting his family know how much all of us have them in our thoughts and prayers.

During this hearing this afternoon, we will hear from Federal Housing Administration (FHA) Commissioner Carol Galante and Housing and Urban Development (HUD) Inspector General David Montoya.

I want to thank both of you for your patience with scheduling this hearing. Both Senator Collins and I had conflicts and had to move this around, and I really appreciate your coming and being here today. FHA is an important issue and your input is really valuable to this subcommittee. So thank you for accommodating our changes and welcome to both of you.

It has been almost 6 years since the housing market collapsed. In the lead-up to that crisis, home prices were on a seemingly unstoppable upward climb while home ownership became a new re-

ality for millions of Americans. But the promises made to homeowners and investors alike were too good to be true, and when the risks associated with these mortgages began to materialize, it was too late to stop the damage.

When defaults and foreclosures skyrocketed, the impact was felt not only by the defaulting homeowners but by entire communities that watched their home values plummet, by investors who bet on these products and lost, and, of course, by older Americans who saw the value of their retirement savings tumble. During this crisis, FHA quickly stepped in to ensure a functioning mortgage market, and there's no question that intervening in the faltering housing market exposed FHA to greater risk.

FHA INSURANCE FUND

But FHA took on this risk in order to support the broader housing market, and without its support, the cost to the market and to taxpayers today would likely have been far higher. Today, we are finally starting to see signs of recovery. New homes are being built. Home sales are up. Foreclosures are down, and home prices are now beginning to rise.

But we are still dealing with the fallout from the housing market's boom and bust. While some homeowners are feeling relief from increased home prices, this is not true for everyone. I still hear from families that are underwater in their homes and unable to refinance. They feel trapped, unable to move to a new job or to a neighborhood with a better school. Unable to refinance at today's historically low rates, they remain saddled with excessive mortgage payments, money that could be better spent on family and at local businesses or saved for their kids' college education.

We are acutely aware of the consequences for FHA and possibly the taxpayer, as the Mutual Mortgage Insurance (MMI) Fund has sustained significant losses in recent years. The President's fiscal year 2014 budget indicates that FHA may require taxpayer funding to cover the losses to its mutual mortgage insurance fund this year. This would represent the first time the fund would need taxpayer funding in its history.

In the past 3 years, HUD has taken numerous steps to strengthen the fund. It has raised insurance premiums five times, it tightened its standards, and it placed new requirements on program participants. Yet the biggest drain on the fund continues to be those older loans originated at the height of the housing market when lending standards and program rules were too lax.

So we must ensure that HUD has the authority it needs and is taking all the steps necessary to mitigate losses from those loans. This includes recovering money from servicers and lenders that did not follow HUD rules and regulations. The $25 billion settlement that 49 States, the District of Columbia, and the Federal Government reached last year with the five largest servicers resulted in $684 million being returned to Federal housing programs.

But the work determining responsibility for losses didn't stop with that settlement. FHA's Office of Inspector General (OIG) and the Department of Justice continue to investigate lenders to ensure that FHA is not paying for losses on loans that should never have been made.

As a result, there have already been five further settlements, bringing the total amount returned to the MMI Fund to over $1.1 billion. I want to thank both the Commissioner and the Inspector General for the important work they're doing on that issue. The taxpayer should not have to pay for losses of lenders who did not follow the rules.

We also need to ensure that the terms of settlement agreements are being honored. And I am concerned by recent reports that some of the banks may not be providing the relief to borrowers that they committed to under the terms of the settlement. So the work to hold the lenders accountable continues.

HOME EQUITY CONVERSION MORTGAGE

While we must hold lenders accountable for not following the rules, we must also make sure that we have the right rules in place. As we discussed with the Secretary when he testified before us several weeks ago, the Home Equity Conversion Mortgage, or HECM, requires careful examination. This product can be a good option for seniors who want to stay in their homes as they get older. But the recent crisis has exposed serious flaws in this program, and it is clear that as currently designed, the program is not working for taxpayers or, in many cases, for borrowers.

Some seniors and their families did not fully understand the product and are now facing foreclosure. These loans have resulted in significant losses to the MMI Fund. In fact, without the HECM mortgages, FHA's insurance fund would have a positive balance. HUD has suggested steps Congress can take to strengthen the program. I know the Inspector General's Office has studied this subject and suggested improvements as well.

So I look forward today to a discussion on how we can work together to preserve a responsible product for people who need it while ending the practices and policies that add unnecessary risks to borrowers and to the FHA's insurance fund.

In addition to HECM changes, HUD, its Inspector General, and the Government Accountability Office (GAO) have identified other steps that can be taken to strengthen FHA. For example, HUD has sought additional enforcement authority to ensure that unscrupulous lenders can't continue to originate FHA-insured loans. And the Inspector General has recommended changes to how HUD manages loans that experience early default.

But it's also important to recognize many of these changes can't be made quickly or at all without the help of Congress. So we need to hear from both of you about what happens if Congress doesn't provide the necessary legislative authority to make additional program changes.

We must also continue to ensure effective management of FHA's programs and operations. For many years, staffing challenges and outdated information systems have compromised effective management of FHA programs. HUD must have staff with the necessary skills to monitor its programs and understand the risks in both the market and its portfolio.

In recent years, this subcommittee has provided HUD with resources to address its staffing needs, including funding for the recently established risk office. Since 2010, Congress has also in-

vested millions of dollars in upgrading FHA's information technology (IT) systems to increase its efficiency and to better detect risk.

The success of the FHA Transformation IT Project is critical to FHA's short- and long-term health. This subcommittee is closely following the management of this project, so I want to discuss its current status as well as its future.

While HUD has made progress in improving its information systems and filling important positions, sequestration creates new challenges for FHA. HUD will be forced to make difficult decisions about which of its IT projects will continue to go forward and which ones will be slowed down or even canceled. Staff will be furloughed, and some positions lost through attrition may not be filled.

SEQUESTRATION

The broad consequence of sequestration cuts across the Government could also impact FHA. Sequestration threatens our fragile economy and housing market. The financial position of the MMI Fund benefits as the housing market and economy improve, but it will also suffer if our economy slows. So we have to continue to work for a fair and balanced solution that provides certainty to our Federal agencies and to the American people.

The budget we recently passed in the Senate provides a path forward that balances responsible spending cuts with necessary investments. I look forward to working with my colleagues in both the House and Senate soon, I hope, to enact a responsible budget compromise.

PREPARED STATEMENT

Ms. Galante and Mr. Montoya, both of you serve in important roles as we continue to deal with the consequences of the housing crash and think through the future of FHA and America's housing finance system, and I look forward to our discussion today.

[The statement follows:]

PREPARED STATEMENT OF SENATOR PATTY MURRAY

LAUTENBERG REMEMBRANCE

Before we begin, I'd like to take a moment to join my colleagues in remembering Senator Frank Lautenberg. Frank was a passionate public servant who was not afraid to fight and vote for what he believed in.

As a member of this subcommittee and former Chairman, Frank added an important voice on the many housing and transportation issues we consider.

He was a tireless advocate for his State and for policies that protected the safety of Americans, whether it was ensuring funding for Amtrak, banning smoking on airlines or strengthening the drunk driving standard. Frank gave everything he had to public service and those who served with him know that it gave him all the satisfaction in the world.

He will be missed by all those who served with him on this committee and here in the Senate.

HEARING INTRODUCTION

This afternoon we will hear testimony from Federal Housing Administration (FHA) Commissioner Carol Galante and Department of Housing and Urban Development (HUD) Inspector General David Montoya.

I want to thank Commissioner Galante and Inspector General Montoya for their patience with the scheduling of this hearing. Both Senator Collins and I had scheduling conflicts that made it necessary to reschedule. But the FHA is an important

issue and your input is valuable to this subcommittee, so thank you for accommodating the changes and welcome.

It has been almost 6 years since the housing market collapsed. In the lead up to the crisis, home prices were on a seemingly unstoppable upward climb while homeownership became a new reality for millions of Americans.

But the promises made—to homeowners and investors alike—were too good to be true. And when the risks associated with these mortgages began to materialize, it was too late to stop the damage. When defaults and foreclosures skyrocketed, the impact was felt not only by defaulting homeowners, but also by entire communities that watched their home values plummet, investors who bet on these products and lost, and older Americans who saw the value of retirement savings tumble.

During this crisis, FHA quickly stepped in to ensure a functioning mortgage market. And there is no question that intervening in the faltering housing market exposed FHA to greater risk. But FHA took on this risk in order to support the broader housing market, and without its support, the cost to the market and to taxpayers today would likely be far higher.

Today, we are finally starting to see signs of recovery:
—new homes are being built;
—home sales are up;
—foreclosures are down; and
—home prices are rising.

But we are also still dealing with the fallout from the housing market's boom and bust. While some homeowners are feeling relief from increased home prices, this isn't true for everyone. I still hear from families that are underwater in their homes and unable to refinance. They feel trapped, unable to move for a job or to a neighborhood with a better school. Unable to refinance at today's historically low rates, they remain saddled with excessive mortgage payments—money that could be better spent on family and at local businesses, or saved for the kids' college education.

We are acutely aware of the consequences for FHA—and possibly the taxpayer as the Mutual Mortgage Insurance (MMI) Fund has sustained significant losses in recent years.

LOSSES TO THE MUTUAL MORTGAGE INSURANCE FUND

The President's fiscal year 2014 budget indicates that FHA may require taxpayer funding to cover the losses to its Mutual Mortgage Insurance Fund this year. This would represent the first time that the fund would need taxpayer funding in its history. In the past 3 years, HUD has taken numerous steps to strengthen the fund. It has:
—raised insurance premiums five times;
—tightened its standards; and
—placed new requirements on program participants.

Yet the biggest drain on the fund continues to be those older loans originated at the height of the housing market when lending standards and program rules were too lax. So we must ensure that HUD has the authority it needs and is taking all of the steps necessary to mitigate losses from these loans. This includes recovering money from servicers and lenders that did not follow HUD rules and regulations. The $25 billion settlement that 49 States, the District of Columbia, and the Federal Government reached last year with the five largest servicers resulted in $684 million being returned to Federal housing programs. But the work determining responsibility for losses did not stop with that settlement.

FHA, HUD's Office of Inspector General, and the Department of Justice continue to investigate lenders to ensure that FHA isn't paying for losses on loans that should never have been made. As a result, there have already been five further settlements bringing the total amount returned to the MMI Fund to over $1.1 billion.

I want to thank both the Commissioner and the Inspector General for the important work they are doing on this issue. The taxpayer should not have to pay for losses of lenders who didn't follow the rules. We also need to ensure that the terms of settlement agreements are being honored. I am concerned by recent reports that some of the banks may not be providing the relief to borrowers they committed to under the terms of the settlement. So the work to hold lenders accountable continues.

HOME EQUITY CONVERSION MORTGAGE LOANS

While we must hold lenders accountable for not following the rules, we must also make sure that we have the right rules in place. As we discussed with the Secretary when he testified before us several weeks ago, the Home Equity Conversion Mortgage, or HECM, requires careful examination. This product can be a good option for

seniors who want to stay in their homes as they get older. But the recent crisis has exposed serious flaws in the program.

And it is clear that, as currently designed, the program is not working for taxpayers, or in many cases, for borrowers. Some seniors and their families didn't fully understand the product and are now facing foreclosure. These loans have resulted in significant losses to the MMI Fund. In fact, without HECM mortgages, FHA's insurance fund would have a positive balance.

HUD has suggested steps Congress can take to strengthen the program. I know the Inspector General's Office has studied this subject and suggested improvements as well. So I look forward to a discussion on how we can work together to preserve a responsible product for people who need it, while ending the practices and policies that add unnecessary risk to borrowers and FHA's insurance fund.

OTHER AREAS OF RISK

In addition to HECM changes, HUD, its Inspector General, and the Government Accountability Office (GAO) have identified other steps that can be taken to strengthen FHA. For example, HUD has sought additional enforcement authorities to ensure that unscrupulous lenders can't continue to originate FHA insured loans. And the Inspector General has recommended changes to how HUD manages loans that experience early default.

But it is also important to recognize that many of these changes can't be made quickly, or at all, without the help of Congress. So we need to hear from both of you about what happens if Congress does not provide the necessary legislative authority to make additional program changes.

FHA OPERATIONS

We must also continue to ensure effective management of FHA's programs and operations. For many years, staffing challenges and outdated information systems have compromised effective management of FHA programs. HUD must have staff with the necessary skills to monitor its programs and understand the risks in both the market and its portfolio. In recent years, this subcommittee has provided HUD with resources to address its staffing needs, including funding for the recently established Risk Office.

Since 2010, Congress has also invested millions of dollars in upgrading FHA's information technology (IT) systems to increase its efficiency and better detect risk. The success of the FHA Transformation IT project is critical to FHA's short and long-term health. This subcommittee is closely following the management of this project, so I want to discuss its current status, as well as its future.

SEQUESTRATION

While HUD has made progress in improving its information systems and filling important positions, sequestration creates new challenges for FHA. HUD will be forced to make difficult decisions about which of its IT projects will continue to go forward and which ones will be slowed down, or even canceled. Staff will be furloughed and some positions lost through attrition may not be filled.

The broad consequences of sequestration cuts across the Government could also impact FHA. Sequestration threatens our fragile economy and housing market. The financial position of the MMI Fund benefits as the housing market and economy improve, but it will also suffer if our economy slows.

So we must continue to work for a fair and balanced solution that provides certainty to our Federal agencies and to the American people. The budget we recently passed in the Senate provides a path forward that balances responsible spending cuts with necessary investments. I look forward to working with my colleagues in both the House and Senate to enact a responsible budget compromise.

CLOSING

Ms. Galante, Mr. Montoya, both of you serve in important roles as we continue to deal with the consequences of the housing crash and think through the future of FHA and America's housing finance system. I look forward to our discussion today.

With that, I am delighted to be joined by my colleague, Senator Collins, and will turn to her for an opening statement.

STATEMENT OF SENATOR SUSAN M. COLLINS

Senator COLLINS. Thank you very much, Madam Chairman. Thank you for holding this important hearing on the Federal Housing Administration and the future of the housing finance market. I join you in welcoming Commissioner Galante and Inspector General Montoya before the subcommittee this afternoon.

The administration has made several announcements regarding our housing policies and programs. Yet there is much more that must be done to stabilize the housing market and to reinvigorate private sector participation. HUD faces many challenges in balancing the goal of strengthening responsible home ownership while minimizing the financial risk to the FHA and to the taxpayer.

Eventually, FHA should play a more limited role, in my judgment, in the mortgage market and help encourage the private sector to reassert its primacy. Nevertheless, I believe there will always be some role for the FHA to play. Since its inception, FHA has provided mortgage insurance for more than 41 million single family home mortgages and 53,000 multifamily mortgages.

FHA continues to partner with current and prospective homeowners during these difficult economic times. In addition to helping FHA program participants refinance at lower interest rates, FHA also assists non-FHA homeowners in refinancing untenable mortgages. A financially sound FHA is an essential component in the recovery of the housing market. The weakening of our housing sector over the past several years has had a tremendous impact on families and communities throughout the Nation. The housing market is slowly coming back, but a sustained recovery is still uncertain.

The agency's role has dramatically expanded since the beginning of this crisis. Prior to the housing collapse, FHA accounted for approximately 3 percent of the single family housing market, reaching upwards of 21 percent in the year 2010. I am pleased to hear that HUD's FHA market share continues to decline as the housing market recovers and that we're now at about 14 percent of market share.

It is, however, troubling to me that year after year, FHA is unable to meet its statutory requirement of maintaining a 2-percent capital reserve ratio. The President's fiscal year 2014 request shows that FHA anticipates drawing on its permanent indefinite budget authority with Treasury for $943 million starting this fiscal year to hold in reserve against expected future losses. If FHA does draw funds from Treasury, it will mark the first time that it has ever needed to take this action.

While HUD has taken a number of steps since January of this year to improve the program, I am concerned about the need to draw this level of funding at the end of the fiscal year. This is attributed to the poor performance of the HECM loans due to borrowers' longevity, house prices declining over recent years, as well as a failure to pay taxes and insurance. We need to ensure that borrowers, especially seniors, are not taken advantage of and are able to make informed decisions regarding their mortgages, both because of the impact on them, but also the impact on the fund.

PREPARED STATEMENT

These are not easy issues to resolve, but they are critically important to our Nation's long-term economic health. I remain concerned that we must reform our present housing finance programs, and in doing so, we must remain mindful of the need to limit the exposure of taxpayers to additional financial losses.

I look forward to working with the chairman, the other subcommittee members, and both of you on these important issues.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF SENATOR SUSAN M. COLLINS

Chairman Murray, thank you for holding this important hearing on the Federal Housing Administration (FHA) and the future of the housing finance market. I join you in welcoming Commissioner Galante and Inspector General Montoya before our subcommittee this morning.

The Administration has made several announcements regarding existing housing programs, yet there is much more that must be done to stabilize the housing market and reinvigorate private sector participation.

The Department of Housing and Urban Development (HUD) faces many challenges in balancing the goal of strengthening responsible homeownership while minimizing the financial risk to FHA and the taxpayer. Eventually, FHA should play a more limited role in the mortgage market and help encourage the private sector to reassert its primacy.

Since its inception, FHA has provided mortgage insurance for more than 41 million single-family home mortgages and 53,000 multifamily mortgages.

FHA continues to partner with current and prospective homeowners during these difficult economic times. In addition to helping FHA program participants refinance at lower interest rates, FHA also assists non-FHA homeowners in refinancing untenable mortgages. A financially sound FHA is an essential component in the recovery of the housing market.

The weakening of our housing sector over the past several years has had a tremendous impact on families and communities throughout the Nation. The housing market is slowly coming back, but a sustained recovery is still uncertain.

The agency's role dramatically expanded since the beginning of the housing crisis. Prior to the crisis, FHA accounted for approximately 3 percent of the single family housing market; reaching upward of 21 percent in 2010. I am glad to hear that HUD's FHA market share continues to decline as the housing market recovers, with just below 14 percent of the market share.

It is troubling that year after year, the FHA is unable to meet its statutory requirement of maintaining a 2 percent capital reserve ratio. The President's fiscal year 2014 request shows that FHA anticipates drawing on its permanent indefinite budget authority with the Department of the Treasury for $943 million during fiscal year 2013 to hold in reserve against expected future losses. If FHA does draw funds from Treasury, it will be the first time that it has ever needed to take this action. While HUD has taken a number of steps since January of this year to improve the program, I am concerned about the need to draw this level of funding at the end of the fiscal year. This is attributed to the poor performance of the home equity conversion mortgage (HECM) loans due to borrowers' longevity, home prices declining over recent years, as well as failure to pay taxes and insurance.

We need to ensure that borrowers, especially seniors, are not taken advantage of and are able to make informed decisions regarding their mortgages.

These are not easy issues to resolve, but they are critically important to our Nation's long-term economic health. I remain concerned that we must reform our present housing finance programs. In doing so, we must remain mindful to limit taxpayers' exposure to additional financial losses.

I look forward to working with you on these important issues.

Senator MURRAY. Thank you very much.

With that, Ms. Galante, we'll begin with you.

STATEMENT OF HON. CAROL GALANTE

Ms. GALANTE. Thank you, Chairman Murray and Ranking Member Collins. I appreciate the opportunity to testify today on the fiscal year 2014 budget proposal.

Before I begin, I did want to take a moment to echo your comments and Secretary Donovan's statement in offering my condolences on the passing of Senator Lautenberg. As a Member of this body, he was a champion of preserving access to affordable housing for all Americans. I join you in mourning his passing.

I also want to thank HUD's Inspector General, David Montoya, and his entire staff for their dedication and partnership as we work to protect FHA and taxpayers.

FHA has played a significant role in lessening the severity of the financial crisis and contributing to our Nation's economic recovery, temporarily increasing its market share to ensure stability and preserve access to credit. However, playing this role during the crisis was not without an impact to our portfolio, requiring decisive action to strengthen FHA.

The Mutual Mortgage Insurance Fund is already seeing strong results from our efforts to improve lender oversight, strengthen credit policies, increase premiums, improve loss mitigation and asset management, and establish a risk management office and portfolio surveillance capability. FHA's new books of business are the strongest in agency history.

FHA SHORTFALL

However, due to loans insured during the crisis as well as stress caused by the HECM reverse mortgage program, the 2014 budget projects that FHA capital reserve will need support from the Treasury. The shortfall is estimated at $943 million. But, as you know, the level of support from Treasury will not be known until the end of the fiscal year. Second, this amount would be added to over $30 billion FHA already has in reserves.

The fund's performance has continued to improve, and if losses from the HECM program are excluded, our actions and the ongoing recovery would leave the capital reserve at positive $4 billion. We look forward to working with Congress on several legislative requests that will further strengthen the fund, increasing our ability to hold lenders accountable, improving recoveries on defaulted loans, and allowing FHA greater ability to respond quickly to risks as they emerge.

One of these requests, granting FHA the explicit authority to make changes to the HECM program via mortgagee letters, is crucial. Given the challenges HECM currently faces, we must make further changes immediately, both to preserve the program and to minimize risk to the fund.

FHA has also proven to be a critical source of financing quality affordable rental homes and healthcare facilities. In fiscal year 2012, FHA supported the construction, improvement, substantial rehabilitation, or refinance of nearly 234,000 apartments and more than 91,000 beds in healthcare facilities. And while our multifamily and healthcare programs were not stressed as severely as the single family portfolio, we have nonetheless made substantial

changes in our risk management and loan review processes, including increasing premiums for the first time in 10 years, protecting these programs for the future.

For fiscal year 2014, we have requested $30 billion in commitment authority for multifamily and healthcare programs. Furthermore, we now estimate that the $25 billion approved for fiscal year 2013 will be insufficient to support the current level of program activity, including refinancing and strengthening our existing portfolio and providing financing for important initiatives such as the Rental Assistance Demonstration Program.

Therefore, we are requesting an additional $5 billion in commitment authority for the remainder of the fiscal year. Without legislative action, we project that we will exhaust our current authority by mid August. In fact, this morning, I notified this subcommittee and others that as of today, we have exhausted 75 percent of our authority for the year.

Finally, our 2014 budget request continues to support transforming the way HUD does business. This means addressing both the infrastructure and processes that support our operations, ensuring that they are compatible with the 21st century financial system. Given the dynamic nature of the mortgage market, it is vital that FHA has the ability to assess and analyze current market trends, borrowers, and lender data for risks.

Through the FHA Transformation Initiative, we have made significant progress in developing and implementing a modern information technology environment. However, without dedicated and sustained funding, we will not be able to implement or maintain these improvements.

Last, another part of our continued efforts is the reorganization and consolidation of the Office of Multifamily Housing at headquarters and in our field offices. These organizational improvements are being undertaken to ensure that even in a constrained budget environment we have an effective delivery model for the future.

PREPARED STATEMENT

While the fiscal year 2014 budget is the result of many tough choices, it is also an opportunity for FHA to continue to support HUD's mission and our Nation's continuing economic recovery while effectively managing risk.

Madam Chairman, thank you for the opportunity to testify today. I look forward to your questions.

Senator MURRAY. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF HON. CAROL GALANTE

Thank you, Chairman Murray and Ranking Member Collins, for this opportunity to discuss how the Department of Housing and Urban Development's (HUD's) fiscal year 2014 budget proposal will grow our economy from the middle class out—not from the top down—while supporting the recovery in our housing market and economy.

As the President has said, housing is an important part of our economic recovery. In 2012, rising home values lifted 1.7 million families back above water and created $1.6 trillion in equity. New home construction levels are at their highest since before the financial crisis and new home purchases are up 12 percent over last year. The number of new foreclosure actions has been cut in half since the height of the

crisis. And the Federal Housing Administration (FHA) has played a critical role in ensuring that we remain on the path to a complete recovery.

This budget provides FHA with the ability to assist HUD in meeting three goals that are critical to the Agency's mission. Using a variety of strategies, it allows us to focus on strengthening the Nation's housing market to support the economy while also protecting consumers. And, despite the challenging fiscal climate, this budget allows us to meet the need for quality, affordable rental homes across the Nation. Finally, this budget continues our efforts to transform the way HUD does business—creating a more modern, efficient, and responsive agency.

GOAL 1: STRENGTHEN THE NATION'S HOUSING MARKET TO BOLSTER THE ECONOMY AND PROTECT CONSUMERS

This Administration entered office confronting the worst economic crisis since the Great Depression—with mortgages sold to people who couldn't afford or understand them, while banks packaged them into complex securities on which they placed huge bets. And while this crisis was largely market driven, the American people have turned to Congress and the Administration for leadership and action in righting our Nation's housing market. HUD remains firmly committed to working together with communities and individuals to cope with the unprecedented challenges facing the housing market.

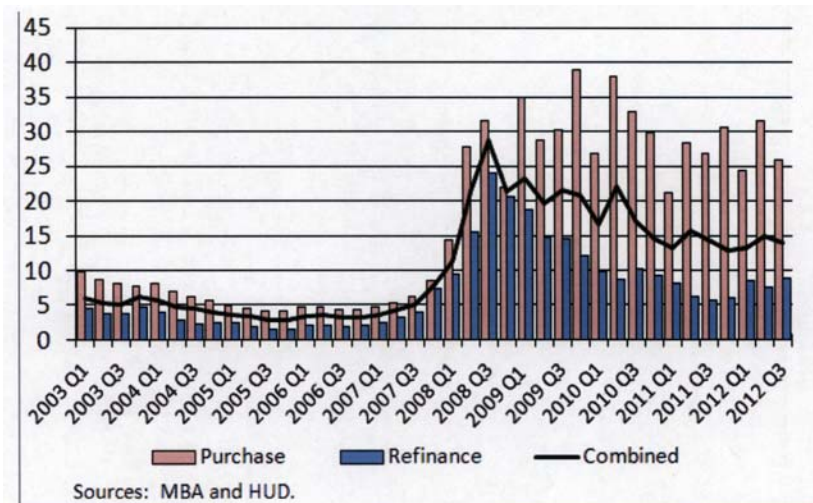
Responding to the Market Disruptions and Serving Underserved Populations

The Federal Housing Administration (FHA), along with the Government National Mortgage Association (GNMA), continues to have a significant impact on the Nation's economic recovery. The activities of the Federal Government are critical to both supporting the housing market in the short term and providing access to homeownership opportunities over the long term, and doing both in a way that minimizes risks to taxpayers.

For fiscal year 2014, HUD is requesting $400 billion in loan commitment authority for the Mutual Mortgage Insurance Fund, which will provide an estimated 1.2 million single-family mortgages—at a projected $199.3 billion in loan volume for forward and reverse mortgage loans as well as loans insured under the FHA Short Refinance program for borrowers in negative equity positions. HUD is also requesting $30 billion in loan guarantee authority for the General and Special Risk Insurance Fund, which will provide an estimated 273,000 units in multifamily housing properties and an estimated 75,700 beds in healthcare facilities. The need for this investment is clear as FHA continues to play an important countercyclical role that has offered stability and liquidity throughout the recession. While a recovery of the housing market is currently underway, FHA continues to act as a crucial stabilizing element in the market, by assuring ongoing access to credit for qualified first-time, low-wealth or otherwise underserved borrowers. However, FHA's expanded role is and should be temporary.

FHA's share of the single family mortgage market (purchase and refinance transactions) has gone from a low of 3.1 percent of loan originations in 2005, up to a peak of 21.1 percent in 2010, and more recently down to 13.9 percent in the 3rd quarter of 2012 (U.S. Housing Market Conditions Report, 3rd Quarter 2012). In fact, the number of FHA single family loan endorsements by loan count, has declined to levels comparable to those seen in fiscal years 2002 and 2003, when FHA's market share was lower than it is today, indicating that FHA's current market share is primarily due to a substantial decrease in the size of the total mortgage market rather than exceptionally high FHA loan volumes. As the market continues to recover and private capital returns at more normal levels, FHA's role will naturally recede and FHA has demonstrated that it is committed to policies that facilitate this return. However, during this crisis, access to FHA insured financing has been critical to bolstering the housing market and providing access to credit to creditworthy, low-wealth borrowers.

Figure 1. FHA Market Share as a Percent of Total Market



As has been true throughout its history, FHA is particularly important to borrowers that the conventional market does not adequately serve, including qualified borrowers who would otherwise be shut out of the mortgage market. According to the latest Home Mortgage Disclosure Act (HMDA) data, half of all African Americans who purchased a home in 2011, and 49 percent of Hispanics, did so with FHA insured financing. Seventy-eight percent of the loans insured by FHA go to first time homebuyers.

FHA Single Family Programs

Redoubling Efforts To Keep Homeowners in Their Homes

While there is work still to be done, HUD is proud of the progress this administration has made in tackling ongoing foreclosure challenges. Between April 2009 and February 2013, more than 6.4 million foreclosure prevention actions were taken—including nearly 1.7 million FHA loss mitigation and early delinquency interventions.

As part of the Administration's commitment to help responsible homeowners stay in their homes, we have actively sought to use our current programs and authorities to make homeownership sustainable for millions of American families. Examples of our efforts include:

—*FHA Streamline Refinance*.—An option that allows borrowers with FHA-insured loans who are current on their mortgage to refinance into a new FHA-insured loan at today's low interest rates without requiring additional underwriting, permitting these borrowers to reduce their mortgage payments. This program benefits current FHA borrowers—particularly those whose loan value may exceed the current value of their home—and, by lowering a borrower's payment, also reduces risk to FHA. And, because we see potential for more widespread use of this product, FHA made changes to the way in which streamline refinance loans are displayed in the Neighborhood Watch Early Warning System (Neighborhood Watch) to encourage lenders to offer this product more widely to homeowners with FHA-insured mortgages, and offered reduced premiums for borrowers who could benefit most from a Streamline Refinance.

—*Changes to FHA's Loss Mitigation Waterfall*.—A mortgagee letter published on November 16, 2012, outlined changes to FHA's loss mitigation home retention options. One of the key elements of this update was moving FHA's Home Affordable Modification Program (HAMP) product up in FHA's loss mitigation waterfall so servicers could more quickly offer deeper payment relief to struggling FHA borrowers, resulting in an increase in the number of borrowers being able to retain their homes.

—*Housing Counseling*.—In fiscal year 2014, HUD is requesting $55 million in Housing Counseling Assistance to improve access to quality affordable housing, expand homeownership opportunities, and preserve homeownership, all of which are especially critical in today's economic climate. With this funding,

HUD estimates that 2,650 HUD-approved counseling agencies, employing an estimated 8,000 housing counselors, will assist a total of 2.5 million renters and owners. In 2012, 2,410 HUD-approved housing counseling agencies, with grant funds from HUD and other funding sources, assisted over 1.9 million renters and owners. HUD-approved counselors help clients learn about purchasing or refinancing a home; rental housing options; reverse mortgages for seniors; foreclosure prevention; loss mitigation; preventing evictions and homelessness; and moving from homelessness to a more stable housing situation.

HUD's new Office of Housing Counseling has several initiatives to ensure borrowers know their rights and have access to the remedies that will allow them to stay in their homes. While HUD approved housing counselors serve all homeowners, regardless of the type of loan, effective loss mitigation for FHA borrowers also protects the Mutual Mortgage Insurance (MMI) Fund. Therefore, HUD has worked closely with interested States to determine effective ways in which funds from the National Mortgage Servicing Settlement can be used to expand housing counseling resources, resulting in more than $300 million in settlement funds committed to housing counseling or legal services for affected borrowers. HUD-approved housing counseling agencies provided foreclosure prevention services to 774,000 families in fiscal year 2012.

In addition, FHA and the Office of Housing Counseling are exploring ways to further integrate housing counseling into the home purchase process, as well as continuing efforts around loss mitigation, offering distressed FHA borrowers additional resources with which to assess their options and make decisions appropriate to their situation.

—*Short Refinance Option*.—In 2010, FHA made available an option that offers underwater non-FHA borrowers, who are current on their existing mortgage and whose lenders agree to write off at least 10 percent of the unpaid principal balance of the first mortgage, the opportunity to refinance into a new FHA-insured mortgage. FHA made enhancements to the program in March of last year and announced an extension to the expiration date of the program in order to increase the number of borrowers who will benefit from this initiative.

Strengthening FHA and Paving the Way for Private Capital To Return

The President's budget shows that FHA, while still under stress from legacy loans, has made significant progress and is on a sound fiscal path moving forward. Like nearly all mortgage market institutions, FHA sustained significant losses due to the precipitous fall in the housing market and home prices and is putting additional funds aside this year to cover those legacy losses. Moreover, like most other market participants, recent and future books of mortgage business are expected to bring healthy gains and perform well.

Throughout the economic crisis, as FHA faced fiscal challenges, this administration took swift and effective action to protect the FHA and the American taxpayer alike, as FHA continued to fulfill its dual mission of supporting the housing market during tough times and providing access to homeownership for underserved populations. Of the changes made since 2009, FHA's lender oversight and credit policies have yielded substantial improvements in the quality of new loans endorsed by FHA, and premium increases have priced appropriately for risk. But significant opportunity remains to reduce the impact on the fund of poorly performing legacy loans severely impacted by the recession, and to provide greater assistance for distressed borrowers as they seek to recover and find meaningful assistance in dealing with their delinquent loans. With a majority of FHA's projected losses attributable to loans insured from 2007–2009, FHA will take several additional steps to maximize recovery in the areas of loss mitigation and asset management.

Counterparty Risk Management and Lender Enforcement

One of the first things this administration did upon taking office was to take strong actions to improve FHA's monitoring and oversight of lenders. This has included substantial improvements to risk analysis systems and procedures, and policy changes to focus resources on the areas of FHA's business which pose the greatest potential risk to the MMI Fund. These efforts have resulted in lenders being withdrawn from FHA programs, improvements in lender compliance with FHA requirements, and a number of settlements with lenders and servicers for violations of FHA origination or servicing requirements.

Yet, it remains important that we continue to clarify and refine the rules of the road for FHA lenders. That is why last month FHA issued a mortgagee letter implementing a Lender Insurance (LI) Lender Indemnification Final Rule which was published in January 2012. This guidance establishes better and more consistent moni-

toring of LI lenders and establishes clearer parameters upon which HUD will require indemnification for loans originated by these institutions.

Additionally, we have been concerned of late with a number of Web-based and print advertisements that proclaim the supposed ease of obtaining an FHA-insured loan following a foreclosure. While FHA has taken a number of proactive steps in the past few years to clarify its requirements regarding lender advertising and to enforce those requirements aggressively, we determined in last year that it was necessary to address the issue of post-foreclosure advertising specifically. Therefore, on January 25, 2013 FHA issued a reminder to its industry partners that advertisements that imply that little or no qualification criteria are necessary to obtain an FHA loan are unacceptable and that FHA will not hesitate to take action within its authority to enforce its requirements related to lender advertising, including sanctions by HUD's Mortgagee Review Board and/or referral to the HUD Inspector General or the Consumer Financial Protection Bureau (CFPB).

Credit Policy

We have also worked to strengthen our credit policies for FHA borrowers. First and foremost, FHA implemented Congress's elimination of seller-funded down payment assistance programs which cost the MMI Fund more than $15 billion in economic value. Further, we enacted increased down payment requirements for borrowers with credit scores below 580. The long-term positive impact of these two credit policy changes cannot be overstated. The 2005–2008 vintages, accounting for less than 15 percent of total originations over the last 30 years, are projected by the Actuary to contribute more than one-third of total credit losses of the fund. Loans with credit scores below 580 and/or seller-funded down payment assistance will have accounted for 44 percent of those losses. Additionally, we will continue work on finalizing regulations to reduce the amount of allowable seller concessions that increase risks to FHA arising from inflated appraisals.

In late 2012, FHA announced several additional policy changes which continue its work to strengthen credit policy, support the ongoing recovery and maintain access to mortgage financing for credit worthy borrowers while also taking steps to recede FHA's total market share. These steps include requiring manual underwriting for borrowers with credit scores below 620 and debt-to-income (DTI) ratios over 43 percent, enhancements to FHA's TOTAL Scorecard, and a proposed increase in the required down payment for borrowers seeking loans in excess of $625,500. Taken together with all the other measures outlined above as well as those detailed in Appendix A of FHA's Annual Report to Congress, these steps will ensure that home buyers using FHA-insured financing are capable of meeting their mortgage obligations and will not put undue stress on the fund.

Increased Revenue

In addition to the improvements made to the quality of new endorsements, we have also made the difficult choice to increase mortgage insurance premiums for FHA-insured loans multiple times in the past 4 years. Since 2009, FHA has increased premiums five times—the most recent increase effective April 1, 2013. Combined, the premium increases made since 2009 have yielded more than $10 billion in additional economic value for the fund to date. These increases have not been undertaken lightly, and FHA has been careful to balance changes to pricing to improve the outlook of the fund with its countercyclical role of providing liquidity and access to credit in the midst of the recent crisis and ongoing recovery.

Additionally, effective beginning with case numbers assigned on June 3, 2013, FHA will cease a policy of canceling required mortgage insurance premiums (MIPs) on loans for which the outstanding principal balance reaches less than 78 percent of the original principal balance. Under that policy, FHA remained responsible for insuring 100 percent of the unpaid principal balance of a loan for the entire life of the loan, a period often extending far beyond the cessation of MIP payments. As written, the timing of MIP cancellation was directly tied to the contract mortgage rate, not to the actual loan loan-to-value ratio (LTV). That policy, which was reversed in a mortgagee letter published on January 31, 2013, was put in place at a time when it was assumed that home price values would not decline, but today we know that LTV measured by appraised value in a declining market can mean that actual LTVs are far higher than amortized mortgage LTV, resulting in higher losses for FHA on defaulted loans. Analyses conducted by FHA's Office of Risk Management projects lost revenue of approximately $10 billion in the 2010–2012 vintages as a result of the current cancellation policy. The same analyses also suggest that 10–12 percent of all claims losses will occur after MIP cancellation. Therefore, beginning in June, FHA plans to once again collect premiums based upon the unpaid principal balance of FHA loans for the entire period during which they are in-

sured, permitting FHA to retain significant revenue that is currently being forfeited prematurely.

Loss Mitigation and Asset Management

The Actuary projects nearly $60 billion in claims costs for FHA from seriously delinquent loans that will go to claim by the end of fiscal year 2014, largely arising from loans insured between 2007 and 2009. As a result, reducing the severity of losses derived from these loans will exert a demonstrable positive impact to Fund performance over the next few years. Throughout the past fiscal year, FHA has been executing on an overall asset management strategy aimed at ramping up real estate owned (REO) alternatives. REO alternatives (primarily short sales) comprised about 15–20 percent of total dispositions since 2010, yielding average loss severities about 20 percent lower than REO. In recent months, as noted, FHA also unveiled its Distressed Asset Stabilization Program (DASP), another REO alternative that improves Fund performance. These and other actions have had a measurable effect, as loss severities have already fallen by 9 percent in the last year. A reduction in loss severities will further improve fund performance. And, compared to March 2012, serious delinquencies are down in March 2013, with non-seasonally adjusted serious delinquencies dropping below 9 percent for the first time in over a year, showing that FHA and the market have made some progress in clearing the backlog of seriously delinquent loans previously withheld from a final disposition.

FHA expects further gains on this front through a number of initiatives:

—*Streamlining of the FHA Short-Sale Policy*.—Although FHA is deeply committed to providing loss mitigation alternatives to borrowers which permit them to retain their homes, home retention is simply not an option for some borrowers. For these borrowers, pre-foreclosure sales (short-sales) offer an opportunity to transition out of their homes. This enables both FHA and the borrowers to avoid the costs and damages of the foreclosure process. This month, FHA will introduce a streamlined pre-foreclosure sale policy which removes certain barriers for borrowers in obtaining a short sale on an FHA-insured mortgage. This change is expected to increase the number of defaulted loans that end in short sales rather than in foreclosures. Because losses from short-sales are substantially lower than from the traditional FHA REO process, the shift of greater numbers of distressed homeowners to short-sale dispositions rather than foreclosures is anticipated to yield better results for the MMI Fund while allowing distressed borrowers to start anew without having to go through the difficult and costly foreclosure process.

—*Claim Without Conveyance Pilot Program*.—FHA is expanding a pilot in which properties secured by non-performing FHA-insured loans are offered for sale by the lender who has completed the foreclosure process. At a reserve price slightly below the outstanding unpaid principal balance of the loan, the properties are sold to third party purchasers without ever being conveyed to FHA. This method of disposing of these properties is expected to yield lower losses for the MMI Fund than selling them through FHA's normal REO disposition process, as carrying costs associated with preserving, managing, and marketing an REO property are eliminated.

—*Proactive Strategies To Further Improve Recoveries*.— In addition to the policy and programmatic changes outlined above, FHA will also take several innovative and proactive steps to increase utilization of loss mitigation options and reduce unnecessary asset disposition losses. First, beginning in 2013, FHA will launch a large-scale proactive marketing campaign to promote modification and short-sale strategies for delinquent borrowers. This effort is expected to increase utilization of these programs, which will permit more borrowers to become aware of and take advantage of these opportunities, while reducing foreclosures and decreasing associated losses for FHA. In addition, FHA will also pursue more creative strategies to dispose of REO properties in geographies where traditional asset disposition methods yield net negative recoveries for FHA. This approach is anticipated to both save money for FHA on unnecessary losses as well as contribute to community stabilization initiatives in cities hit hard by the recession.

Due to these changes, resulting in higher quality of loans and reduced loss severities, and combined with the large volume of current loans, we project FHA will generate approximately $18 billion in receipts during fiscal year 2013. This includes $3 billion generated from the new premium increase that went into effect April 1, 2013, and reversal of a policy that caused FHA to forfeit collection of MIP after a loan reached 78 percent of its original principal balance. Further, as a result of these same changes, the fiscal year 2014 budget projects FHA receipts of almost $13 billion, even as FHA market share and loan volume continue to be reduced.

Fiscal Year 2013 MMI Fund Budget Re-Estimate

The President's budget forecasts that the FHA MMI Fund, which provides the fiscal capital to support FHA's single family and reverse mortgage guarantees, will use $943 million of its mandatory appropriation authority to supplement its reserves at the end of fiscal year 2013. The MMI Fund currently has approximately $32 billion in cash available to pay claims, so this is not a cash on hand problem; it is one of setting aside the right size of loan loss reserves. The $943 million figure is based on an annual re-estimate of the reserves FHA will need to hold as of September 30, 2013, for the payment of expected losses over the next 30 years on its portfolio of guaranteed loans as of last September, based upon Federal Credit Reform Act (FCRA) scoring. This re-estimate is done as part of the development of the President's budget.

The potential for a mandatory appropriation to the MMI Fund is largely due to the existing reverse mortgage (Home Equity Conversion Mortgage or HECM) portfolio. This product, particularly as it has been structured to date, is sensitive to borrower longevity, home prices, and economic conditions. Lower than anticipated home price appreciation substantially affected the expected performance of the portfolio. Further, changes to the ways in which borrowers utilize the HECM product have shifted the risk profile of the program.

Originally designed to be used like an annuity, in recent years market circumstances and lender preferences have shifted greater numbers of borrowers to take full draws via the Fixed Rate Standard product. Thus, borrowers are taking all of the funds available to them up front and often do not have the resources necessary in later years to pay property taxes and insurance, thereby triggering a default on the loan. Due to these changes in usage and performance, the budget estimates that the use of the HECM program results in a negative value of $5.248 billion and a disproportionately negative impact to the fund.

FHA will take immediate action under its limited authorities to better align the HECM program with its objective of enabling seniors to age-in-place. These changes, which will significantly impact consumer use of the program, will protect FHA from losses and reduce the likelihood of borrower defaults.

In administrative guidance dated January 30, 2013, FHA consolidated the Fixed Rate Standard program with the Fixed Rate HECM Saver product, which will result in a reduction of the maximum amount of funds available to a HECM borrower.

Additionally, in an effort to reduce losses associated with the conveyance and disposition of properties mortgaged with an HECM, FHA will issue new incentives for estate executors of HECM borrowers to dispose of properties themselves rather than conveying them to HUD. Executors are permitted to either sell such properties or convey them to HUD. Reversing the historical trend, over the past few years, larger numbers of executors have been choosing to convey these properties to FHA rather than sell them, adding costs and reducing recoveries for FHA. By incentivizing the sale of properties by executors, FHA is able to avoid property management, maintenance, and marketing costs associated with the REO disposition process, thereby reducing losses to the fund on these properties.

Whether there will be an actual need for a mandatory appropriation from the Treasury General Fund to the MMI fund will not be determined until September 2013, and will be based on FHA's realized revenues and any other developments through the end of the fiscal year. Notably, any mandatory appropriation to FHA would not involve approval from Congress, as all Federal loan programs have this standing authority. As we consider this potential mandatory appropriation, we must also acknowledge that FHA played a crucial, countercyclical role in bringing the housing market from the brink of collapse to a place where it is positive and growing again. This task did not come without its stresses which we are experiencing today. Nevertheless, FHA will remain vigilant in implementing the policies and practices discussed here to protect the fund.

Legislative Requests To Support FHA Single Family Programs

Since 2010, Congress has moved in important ways to strengthen and protect FHA. Indeed, were it not for the flexibility granted by Congress to FHA in setting mortgage insurance premiums, the current economic value of the MMI Fund would be more than $10 billion lower than it is today. And the work Congress has done to establish FHA's first ever Office of Risk Management has been instrumental to our improved ability to identify risks in FHA programs and take action to mitigate them. We appreciate the commitment to making FHA stronger and more secure over the long term.

We have several legislative requests that, when coupled with actions taken previously and the support provided by this budget, will allow us to further strengthen the FHA fund and the larger housing market. The proposals outlined below will en-

hance FHA's ability to hold lenders accountable for non-compliance with FHA policy, allow FHA to increase recoveries on defaulted loans, and provide greater flexibility for FHA to make changes to policies and procedures as emerging needs and trends are identified. As a result, FHA will better be able to avoid unnecessary losses before they occur.

—*Indemnification Authority for Direct Endorsement Lenders*.—This provision, which FHA has been seeking since 2010, would allow FHA to seek indemnification from Direct Endorsement lenders, which represent 70 percent of all FHA approved lenders. Currently FHA only has authority to require indemnification for lenders with Lender Insurance (LI) approval. In granting this authority, FHA will be able to obtain indemnification from all of its approved lenders for loans that do not comply with its guidelines.

—*Authority To Terminate Origination and Underwriting Approval*.—This legislation would give FHA enhanced ability to review lender performance and, if a lender is found to have an excessive rate of early defaults or claims, would provide greater flexibility in terminating the approval of the lender to originate or underwrite single family mortgages for FHA insurance. FHA has been seeking this authority since 2010.

—*Revised Compare Ratio Requirement*.—This provision would revise the statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance so that it more effectively captures the true performance of a lender during all market conditions, minimizing further poor performance by FHA lenders while reducing uncertainty for them. Specifically, this legislation would allow the Secretary to compare the rate of early defaults and claims for insured single family mortgage loans originated or underwritten by a lender with those same rates for other lenders on any basis the Secretary determines appropriate, such as geographic area, varying underwriting standards, or populations served. Further, the provision would permit the Secretary to implement such comparisons via regulations, notice, or mortgagee letter. This will allow FHA to tailor the compare ratio so it provides meaningful comparisons of lenders in varying market conditions, providing greater clarity for lenders and a more refined understanding of their performance for FHA.

—*Authority To Transfer Servicing*.—In order to facilitate more effective loss mitigation, this change would give FHA the authority to require any of the following actions when a servicer is at or below a servicer tier ranking score (TRS) of III, or when the Secretary deems the action necessary to protect the interests of the MMI Fund: (1) transfer servicing from the current servicer to a specialty servicer designated by FHA; (2) require a servicer to enter into a sub-servicing arrangement with an entity identified by FHA; and/or (3) require a servicer to engage a third-party contractor to assist in some aspect of loss mitigation (e.g. borrower outreach). Such authority would permit FHA to better avoid losses arising from poor servicing of FHA-insured loans, yielding better results for both borrowers and FHA.

—*Authority To Structurally Change the HECM Program Through Mortgagee Letter*.—While the HECM product is an important tool to permit seniors to age in place, the challenges outlined previously necessitate immediate changes to the program. To make such changes in a timely fashion and preserve the program for seniors, FHA is seeking statutory authority to temporarily make changes to the HECM program via mortgagee letter while formal rule making is simultaneously in progress. Specifically, FHA would make the following changes via mortgagee letter:

—Limit the amount of the allowable draw;

—Mandate the use of escrow accounts to ensure continued and timely payment of property charges including taxes and insurance, and;

—Require the use of a financial assessment as part of the loan origination process to ensure the appropriateness of HECM products for potential borrowers.

These changes will enable FHA to ensure that new HECM originations meet the needs of the target population and reduce risks to the MMI Fund. Absent ability to make these structural changes, later this fiscal year, FHA will have to take more dramatic action to ensure that new HECM originations are actuarially sound.

HECM Non-Borrowing Spouse.—The intent of the HECM program is to provide an age-in-place option for senior citizen homeowners. However, from an operational standpoint, those homeowners must be party to the reverse mortgage for HUD to manage an actuarially sound program. Currently, if a mortgagor dies and no other HECM mortgagor continues to reside in the home, the loan becomes due and payable. The Department believes that in order to benefit from the HECM loan, a party must be eligible under the terms of the HECM, including the requirement that one

be aged 62 or older and also have legal claim to the property. In order to clarify the responsibilities of non-borrowing spouses under the HECM program, HUD is proposing a general provision in the fiscal year 2014 budget that amends the National Housing Act to clarify that the HECM becomes due and payable upon the death of the mortgagor spouse in order to avoid future misunderstanding. The proposed amendment would make clear that HUD's longstanding regulations—in effect since the beginning of the program—comport with Congress' original intent.

GOAL 2: MEET THE NEED FOR QUALITY, AFFORDABLE RENTAL HOMES AND HEALTHCARE FACILITIES

At a time when more than one-third of all American families rent their homes and over 8.5 million unassisted families with very low incomes spend more than 50 percent of their income on rent and/or live in severely inadequate conditions, it is more important than ever to provide a sufficient supply of affordable rental homes for families of modest means—particularly since, in many communities, affordable rental housing does not exist without public support. Compounded by an aging population and increasing healthcare costs, strong support for quality, accessible healthcare is also an essential component in achieving the Department's mission of strong, sustainable, inclusive communities and quality, affordable housing and services for all Americans.

Office of Multifamily Housing Programs

Reducing Administrative Burdens and Increasing Efficiency

This budget recognizes the need to simplify, align, and reform programs to reduce administration burdens and increase efficiency across programs. The Office of Multifamily Housing is beginning to realize savings in salaries and expenses as a result of several major initiatives.

—*Breaking Ground*.—Completed in mid-fiscal year 2012, Breaking Ground was an initiative in Multifamily Housing Development to reduce backlogs, improve timeframes, and create an early warning system that allows for more effective risk management by creating extensive tools to monitor and access credit for multifamily insured loans. These tools include a stronger credit review of borrowers; an early warning system that targets loans early in the process that do not meet FHA underwriting criteria; and a dashboard monitoring tool to track accountability of field offices; and establishment of a queue in order to more efficiently manage workload and provide greater transparency to lenders.

Adopting this approach has produced positive results. Offices that had large application backlogs prior to Breaking Ground have reported processing efficiency improvements, methodically clearing out older applications—the number of applications in process for over 90 days dropped from 191 to 50 in just 7 months. In addition, offices that began Breaking Ground without a large backlog have begun to meet aggressive application processing time cycles. The Department will continue to track these metrics and looks forward to reporting on these results.

—*Sustaining Our Investments*.—The Sustaining Our Investments initiative, which was fully implemented last month, has resulted in an overhaul of the processes used to manage the portfolio of the Office of Multifamily Asset Management. The initiative focuses on Risk Based Management—allowing project managers at both the headquarters and field level to focus day-to-day operations on managing at-risk loans in the portfolio. Risk-based reports keyed on financial and physical risk triggers direct project managers to act early on potential problems with particular assets. The first step in this initiative was to complete a full ranking of FHA's entire multifamily market rate portfolio to better assess and address potential risk factors. The ranking of the non-insured portfolio is now underway.

—*Loan Committee*.—FHA Multifamily has also implemented a new loan committee approval process, aligning Hub and Program Center commitment authority and practice to ensure consistency in underwriting throughout the regional offices, as well as to provide a platform to share best practices. Loan committees at the hub and national levels provide oversight for high-risk transactions in the multifamily insurance program, based on loan size and a project's number of units. Loan committee approval processes are standard practice in the lending community and are an important tool to prudently manage credit risks and ensure the integrity and stability of the General and Special Risk Insurance (GI/SRI) insurance fund. The Loan Committee has also proven to be an effective tool for increasing communication and a more consistent FHA platform.

Adjusting Premiums To Properly Price for Risk

Given the unprecedented increase in the number and dollar volume of loans insured under the GI/SRI, particularly with respect to "market rate[1]" loans, in the President's fiscal year 2013 budget proposal, the Department announced proposed premium increases for programs in the GI/SRI. Implemented on October 1, 2012, this was the first premium increase in 10 years for these programs.

GI/SRI funds provide financing for the FHA multifamily and healthcare loan guarantee programs and several very small specialized loan products. This account also continues to hold a sizable portfolio of single family loan guarantees (HECM, condominium, and rehabilitation loans) insured prior to fiscal year 2009 when responsibility for new lending under these programs was transferred to the Mutual Mortgage Insurance Fund.

In contrast, premiums for single family programs situated in FHA Mutual Mortgage Insurance (MMI Fund) have been increased four times since 2010. As with the premium increases for MMI programs, higher premiums for market rate loans originated under the GI/SRI funds ensure that FHA products are priced appropriately to compensate for FHA's risk, consistent with current market conditions. This premium change should also have the indirect benefit of encouraging the return of private capital to the Nation's mortgage markets.

Going forward, FHA will continue to examine its business models and practices, with an eye toward continuing to improve its risk management capabilities and operational efficiencies while expediting processing and approval timelines.

Rebuilding Our Nation's Affordable Housing Stock

Over the last 75 years, the Federal Government has invested billions of dollars in the development and maintenance of public and multifamily housing, which serve as crucial resources for some of our country's most vulnerable families. Through its mortgage insurance programs, over just the past 18 months, FHA facilitated lending of $4 billion for new construction and substantial rehabilitation of over 40,000 apartment units. FHA insured over $11 billion of mortgages that supported improvements and moderate rehabilitation of more than 150,000 units of multifamily housing over the same period.

Despite this sizable Federal investment and the great demand for deeply affordable rental housing, we continue to see a decline in the number of available affordable housing units. Unlike other forms of assisted housing that serve very similar populations, the public housing stock is nearly fully reliant on Federal appropriations from the Capital Fund to make capital repairs. Funding and regulatory constraints have impaired the ability for these local and State entities to keep up with needed life-cycle improvements. The most recent capital needs study of the public housing stock, completed in 2010, estimated the backlog of unmet need at approximately $26 billion, or $23,365 per unit. Available funding is vastly insufficient to meet accruing needs of approximately $3 billion per year. Under the strain of this backlog, and without financing tools commonly available to other forms of affordable housing, the public housing inventory loses an average of 10,000 units annually through demolitions or dispositions. Through FHA and other programs, HUD is taking steps to address this shrinking inventory.

Rental Assistance Demonstration

In addition to the public housing stock, the Rental Assistance Demonstration (RAD) program targets certain "at-risk" HUD legacy programs. The 24,000 units assisted under section 8 Moderate Rehabilitation (MR) are limited to short-term renewals and constrained rent levels that inhibit the recapitalization of the properties. The approximately 21,000 units assisted under Rent Supplement (RS) and Rental Assistance Program (RAP) have no ability to retain long-term project-based assistance beyond the current contract term. As a result, as their contracts expire, we can no longer depend on these projects to be available as affordable housing assets.

Conversion to long-term section 8 rental assistance, as permitted under RAD, is essential to preserving these scarce affordable housing assets and protecting the investment of taxpayer dollars these programs represent. Long-term section 8 rental assistance allows for State and local entities to leverage sources of private and public capital to rehabilitate their properties. While the Department expects and continues to process public housing conversions of assistance without additional subsidy, HUD requests $10 million in fiscal year 2014 for the incremental subsidy costs of converting assistance under RAD for very limited purposes. Such funding will be

[1] Generally, market rate housing covers a range of rental housing opportunities. In the FHA portfolio, market rate housing is generally affordable to those at approximately 80 percent of area median income.

targeted only to public housing projects that are: (1) not feasible to convert at current funding levels; and (2) located in high-poverty neighborhoods, including designated Promise Zones, where the Administration is supporting comprehensive revitalization efforts. The Department estimates that the $10 million in incremental subsidies will support the conversion and redevelopment of approximately 3,300 public housing units that would not otherwise be feasible to convert and sufficiently stabilize over the long-term, while helping to increase private investment in the targeted projects and surrounding neighborhoods.

In addition to the funding request, each of the legislative requests in the 2014 budget for RAD are designed to allow for maximum participation by those public housing agencies (PHAs) and owners whose current funding levels are sufficient for conversion. In the first component of RAD, an increase in the 60,000 unit cap to 150,000 units, and the exclusion of section 8 MR properties from the cap will both allow for a greater portion of both the public housing and MR stock that can convert at no cost to the Federal Government to participate in the demonstration. It is expected that approximately 40 percent of the transactions conducted through the RAD program will leverage FHA insured financing, actually contributing to the generation of offsetting negative subsidy receipts for the Government.

Legislative Requests To Support Multifamily Housing

Nearly a third of the Nation's renters, more than 20 million households, live in small, unsubsidized apartment buildings. These 5- to 49-unit properties tend to be owned by small businesses and are typically more affordable to low and moderate income families. These properties are at risk of continued disinvestment as small building owners are less likely than other multifamily property owners to be able to secure financing for repairs and improvements. Small properties are less likely to have mortgage financing and just 14 percent of all fiscal year 2010 FHA-insured properties were for projects with fewer than 50 units.

The fiscal year 2014 budget includes a legislative provision to support small building finance, and to strengthen the Risk Share program as a rental finance tool, seeks congressional authority for Ginnie Mae to guarantee securities containing FHA multifamily Risk Share loans, thereby increasing liquidity and decreasing cost of capital. This proposal would apply to both State and local Housing Finance Agency Risk Share lenders under section 542(c) and new Risk Share lenders under section 542(b). The proposal would also amend section 542(b) of the statute to allow for flexibility in how affordability is determined in order to make it a more effective tool to recapitalize existing naturally affordable 5–49 unit rental properties.

Section 542(c) HFA Risk Share.—The extension of Ginnie Mae securitization to the 542(c) Risk Share program would improve HFAs' ability to finance affordable rental housing that serves some of the poorest and most vulnerable Americans, without requiring any Federal budgetary appropriation.

Section 542(b) Risk Share and Small Building Finance.—The 542(b) Risk Share authorizing statute provides HUD with significant flexibility to take on risk-share partners. HUD plans to partner with mission-driven lenders to make loans on small multifamily rental buildings on a 50/50 risk share basis with HUD. In order for this program to work for small multifamily lending, two legislative changes are required. Access to Ginnie Mae guarantees for small building risk-share lenders combined with flexibility on the statutorily imposed risk share affordability standard which otherwise requires ongoing rent and income restrictions will allow us to use this tool to meet the needs of these smaller properties and prevent disinvestment in a valuable portion of our Nation's housing stock.

Office of Healthcare Programs

FHA's healthcare programs for hospitals and residential care facilities (nursing homes, assisted living facilities, and board and care homes) have helped private lenders fill the gap left by shrinking conventional finance resources. Since 1934, over 4,000 residential care facility mortgage insurance commitments were issued in all 50 States under the section 232 program. In 1968, enabling legislation amending the National Housing Act was signed into law, creating the section 242 program for hospital facilities. Since the section 242 program's inception, over 400 mortgage insurance commitments have been issued for hospitals in 42 States and Puerto Rico. And while the economy seems to be rebounding and with it, sources of private capital, we continue to expect high levels of mortgage insurance activity for fiscal year 2014 due in large part to refinancing activity as healthcare facilities take advantage of current low interest rates. Furthermore, following implementation of a final rule in 2013, hospitals can now obtain FHA-insured refinancing loans. As of December 31, 2012, the FHA's portfolio of healthcare loan guarantees had an unpaid principal balance of $28.3 billion on 2,900 loans.

Evolution of FHA Healthcare Programs—Balancing Risk and Improving Processes

This Administration, in continuing to improve the program has brought in positive risk management changes to both balance risk and improve processes. Given the unprecedented increase in the number and dollar volume of loans insured under GI–SRI, in fiscal year 2013, premium increases for FHA's General Insurance and Special Risk Insurance healthcare programs were instituted to increase the stability of the insurance fund. With the premium increases, FHA healthcare loans are priced more appropriately to encourage the return of private capital while, at the same time, continuing to ensure sufficient levels of available capital in these sectors.

Proactive Asset Management.—In FHA's Office of Healthcare Programs, weekly loan committees are held to review and approve loan submissions and to monitor healthcare industry trends and risks. By implementing proactive asset management using early intervention monitoring tools, the Office of Healthcare Programs succeeded in maintaining claim rates of less than 1 percent in both healthcare facility mortgage insurance programs in fiscal year 2012.

LEAN Business Process Reengineering.—LEAN Business Process Reengineering has also played an integral part in streamlining business operations within FHA's healthcare programs. Despite volume increases, LEAN processing improvements reduced loan processing times while increasing risk management efforts. Revised program requirements and documents were established to enhance accountability for borrowers, operators, and lenders. To further manage risk in the healthcare portfolio, in areas of large risk concentrations, such as insuring portfolios of multiple healthcare facilities, reviews are conducted at both the corporate and individual loan levels. In the residential care facility mortgage insurance program, implementation of a Master Lease Structure to cross-collateralize properties not only works to improve the overall risk profile of FHA's healthcare portfolio, but ultimately reduces claims.

The Office of Healthcare Programs is in ongoing collaboration with the Department of Health and Human Services (HHS), Centers for Medicare and Medicaid Services (CMS), and State public health departments to support efforts to ensure quality of care for the most vulnerable populations. Also, by incorporating State survey inspection results, cost reports, and data from other Federal and State agencies into FHA's underwriting and asset management procedures, the shared utilization of data and cross-collaboration has been instrumental in keeping healthcare claim rates low within FHA.

Legislative Request To Support Healthcare Programs

As part of the efforts of FHA's healthcare programs to strengthen communities by addressing specialized financing needs, HUD is seeking passage of the language in the Transportation, Housing and Urban Development, and Related Agencies (THUD) appropriations bill to permit rural Critical Access Hospitals to be eligible for FHA insurance. Before their eligibility expired in 2011, 29 Critical Access Hospitals received FHA-insured loans, with results that were positive, both in terms of loan performance and the jobs created by hospital construction projects. Also, quality of life improved in their communities; these hospitals by definition are geographically remote from other hospitals, and they provide not only emergency, outpatient, and acute inpatient services but also nursing and rehabilitation services that avoid the need for the elderly and recuperating patients to leave the community for care.

We appreciate the Congress' longstanding support for Critical Access Hospitals by amending section 242 to permit these important facilities to be eligible for FHA insurance, and hope that this language will be approved to allow Critical Access Hospitals to continue to be eligible for FHA insurance.

GOAL 3: TRANSFORM THE WAY HUD DOES BUSINESS

A 21st century American economy that is a magnet for jobs and equips its residents with the skills they need for those jobs demands a Government that's leaner, smarter, and more transparent. The current economic and housing crisis; the structural affordability challenges facing low-income homeowners and renters; and the new, multidimensional challenges facing our urban, suburban, and rural communities all require a HUD and an FHA that can meet those challenges. As such, we remain committed to improving the way HUD does business. HUD remains at the forefront of the Federal response to the national mortgage crisis, economic recovery, Hurricane Sandy recovery, and the structural gap between household incomes and national housing prices—roles that require an agency that is nimble and market-savvy, with the capacity and expertise necessary to galvanize HUD's vast network

of partners. HUD's 2014 budget reflects these critical roles, by investing in transformation, research, and development that will be implemented persistently over time.

Strategically Investing in Our Staff While Improving Efficiencies and Processes

HUD's greatest resource is its dedicated staff. When employees attain skills and are motivated to use those skills to help their organization reach goals, the capacity of the organization grows and employees in the organization grow as well. This is why HUD is providing its employees training and leadership development opportunities. HUD is also in the process of simplifying and streamlining programs and reforming its information technology, human resources, procurement, and other internal support functions to provide flexibility to managers and better service to HUD customers.

Multifamily Office Reorganization and Consolidation

Beginning in fiscal year 2013, the Office of Multifamily Housing will begin reorganizing its headquarters structure and consolidating field office operations. Phased in over 2½ years, this plan will increase efficiency and consistency, modernize our services, and once fully implemented has the potential to save an estimated $40 million to $45 million in annual costs.

By taking proactive steps, the Office of Multifamily Housing Programs will better serve customers and stakeholders, by operating more efficiently and consistently and improving risk management, all in an era where HUD and agencies across the Government are working diligently to determine how best to do more with less. This transformation builds upon the success of Breaking Ground and Sustaining Our Investments through four initiatives:

—*Launching More Routine and Effective Workload Sharing Across the Country*.—By more equitably distributing workloads in the areas of Production and Asset Management, Multifamily Housing will be able to reduce unevenly distributed pressure on staff and reduce customer wait times and the application backlog. A workload sharing pilot is already in process throughout the country, receiving positive feedback from customers and staff.

—*Introducing Risk-Based Processing and Underwriters in the Office of Multifamily Production*.—In order to increase processing efficiencies, improving customer service and more effectively manage risk, FHA Multifamily will segment and process applications according to their risk profile and complexity, assigning an underwriter to oversee the review of the application from start to finish, drawing in technical experts as needed.

—*Creating Specialist Support in the Office of Multifamily Asset Management*.—The newly created positions of Troubled Asset Specialist and Account Executives will allow Multifamily to assign the most experienced staff to focus on risky, complex or troubled assets, ensuring that the most skilled staff is engaged to manage risk to the portfolio. Other Account Executives with less expertise will focus on non-troubled portfolio while building the expertise and skill sets to manage more complex transactions.

—*Streamlining Organizational Structures*.—In headquarters, FHA Multifamily will reduce the number of offices by merging the Office of Housing Assistance and Grants Administration and the Office of Housing Assistance Contract Administration Oversight into other existing headquarters offices. A dedicated Associate Deputy Assistant Secretary role will be created to support the field while leadership also examines other offices for ways to streamline and reduce duplication of efforts. In the field, 17 hubs will be consolidated into 5—and the total number of field offices with Multifamily presence will decline from 50 to 10. Affected employees will have the ability to relocate, accept a buy-out, or take early retirement.

Upgrading the Department's Information Technology Infrastructure

In fiscal year 2014, HUD is requesting $285 million to support and modernize its information technology (IT) infrastructure. This request includes $45 million for the development, modernization, and enhancement of key outdated systems; $116 million for the operations and maintenance of our current systems; and $124 million to complete the transition to our new IT infrastructure system, HUDNET. Department-wide efforts will focus on transitioning the department to a modern, sustainable IT infrastructure, and to continue the development of a modern financial management system that will improve HUD's ability to measure, track, and report on program costs and efficacy, and transitioning the current FHA systems to a modern platform. These steps are integral to the build the FHA systems and tools needed to manage risk.

FHA in particular expects to expand its portfolio evaluation tool capacity to get an "early look" at where the value of the MMI fund is trending, and to incorporate new business policies or products when/where needed. HUD has begun to decommission legacy FHA applications and will continue this through the fiscal year 2014 request, freeing up those IT dollars for reinvestment. These changes will allow HUD to deliver services and manage its multi-billion dollar programs faster, more accurately and using better information for analysis. These funds are crucial to complement HUD's transformation efforts, providing resources for maintaining and improving Department-wide information technology systems.

CONCLUSION

Madam Chairman, the HUD budget reflects the Administration's recognition of the critical role the housing sector must play to ensure that America becomes a magnet for jobs that strengthen the Nation's middle class, including providing ladders of economic opportunity for all Americans. Equally important, it expresses the confidence of the President in the capacity of HUD to meet a high standard of performance.

By targeting resources where they are most needed, making tough choices in order to do more with less, and ensuring the protection of taxpayer interests, FHA's Single Family, Multifamily, and Healthcare Programs, are ensuring more Americans have the opportunity to realize or maintain the economic security of the middle class. Our focus on transforming the way we do business will ensure that we can continue to remain a relevant and effective support to the housing market—one that helps build the economy from the middle class out and ensures that we create opportunity for everyone, everywhere. Thank you.

Senator MURRAY. Mr. Montoya.

SUMMARY STATEMENT OF HON. DAVID A. MONTOYA

Mr. MONTOYA. Thank you, Senator. Chairman Murray, Ranking Member Collins, I am David Montoya, the Inspector General for the Department of Housing and Urban Development. We join you in remembering Senator Lautenberg's contributions to the United States.

I want to take the opportunity to thank you for inviting us to discuss issues on FHA and also to thank the Commissioner for her collaborative efforts with my office over the last 1½ years that I've been there and some of the changes that we've been looking to make with them.

FHA is an important spoke in the Nation's housing industry, as FHA-insured mortgages finance approximately one-fourth of all home purchases in the United States. For this reason, my office has been aggressive in its oversight of the FHA program. In fact, over the years, my office has consistently expressed concerns about the level of oversight and risk taken on by FHA and the effect this has had on its financial health.

PROPOSED RULEMAKING REQUIREMENTS

Unfortunately, and for a number of reasons, FHA has been slow to respond to many of our recommendations. One reason is FHA's requirement for proposed rulemaking. This process can take years to finish and delays FHA's ability to make regulatory changes or respond quickly to market conditions and financial forces. Another reason for the slowness is a reluctance, at times, to adopt our recommendations because of FHA's concern over the impact changes would have on its market share and how such changes would affect the industry.

One notable example dates back to 1999 regarding recommendations my office made back then to discontinue the use of seller-

funded downpayment assistance. It took almost 9 years for FHA to change this practice, and that inaction reverberates today as these loans are expected to cost the Mutual Mortgage Insurance Fund over $15 billion.

In another example, the Office of Inspector General testified in 2009 about FHA taking on new risks, such as the expansion of FHA's HECM program that you just mentioned. This product has disproportionately and negatively impacted the MMI Fund, and the President's budget has assigned a negative value of approximately $5.2 billion to the HECM portfolio for 2013. Overall, FHA estimates that it will need to use just under $1 billion of its appropriation authority to supplement its reserves, largely due to the poor performance of the HECM portfolio.

It remains that the fund has failed to maintain a capital ratio of 2 percent for the past 4 years and each year has seen a further decline in the fund's economic value, which has now fallen to a negative $16.3 billion. Based on current actuarial projections, the capital ratio will now not reach the 2 percent level until 2017, which would represent 8 years continually below the 2 percent threshold mandated by Congress.

REAL ESTATE-OWNED PROPERTIES

In addition to unprecedented levels of claims, approximately $67 billion in just the last 4 years, FHA can expect to see a continuing influx of claims for the foreseeable future. FHA's reported default rate on seriously delinquent loans as of January 2013 stood at approximately 9.5 percent. Based on our analysis of FHA data, the total unpaid balance on FHA's single family loans in default now exceeds $100 billion.

HUD also continues to face challenges in managing its inventory of real estate-owned (REO) properties. HUD's oversight will be critical to ensure that returns on property sales are maximized, thereby reducing further losses to the fund. FHA's losses on REO property sales exceeded $9 billion in 2012.

Another significant concern we continue to express is FHA's ability to perform required financial management functions on legacy systems that are at least 15 to 30 years old. FHA needs to enhance its integrated insurance and financial systems. Unfortunately, FHA's ability to replace the antiquated infrastructure on which many FHA single family applications reside has been delayed.

While FHA has taken various measures to restore the financial health of the fund, we think more can be done with adjustments to their actuarial modeling and in the area of risk management and lender oversight. With regard to lender oversight, my office continues to conduct reviews that have shown high percentages of loans containing not only significant deficiencies, but material incurable violations of HUD underwriting requirements and standards that expose the fund to an unacceptable level of risk and claims that FHA never agreed to take on under the insurance program.

In conclusion, we remain concerned over the lack of flexibility that would allow FHA to respond to market changes and to our recommendations in a more timely way. FHA's competing mandate to continue its role in restoring the housing market, ensuring the

availability of mortgage credit, and continued lender participation in the FHA program should heighten these concerns for policy makers.

My office is strongly committed to working with the Department and the Congress to ensure that FHA remains the viable and strong program it was intended to be.

PREPARED STATEMENT

This concludes my testimony. Again, thank you for allowing me to speak to you today. I look forward to answering questions.

[The statement follows:]

PREPARED STATEMENT OF HON. DAVID A. MONTOYA

Chairman Murray, Ranking Member Collins, and members of the subcommittee, I am David A. Montoya, Inspector General of the U.S. Department of Housing and Urban Development (HUD). Thank you for the opportunity to discuss the oversight of the Department that my office conducts and current issues relating to the Federal Housing Administration (FHA).

As part of the Department's primary mission to create strong, sustainable, inclusive communities and quality, affordable homes for all, HUD also assists families in obtaining housing by providing FHA mortgage insurance. HUD is an important spoke in the Nation's housing industry in that FHA-insured mortgages finance approximately one-fourth of all home purchases in the United States.

Since becoming the Inspector General, I have had an ongoing dialogue with FHA Commissioner Carol Galante on the challenges that the Department and FHA face and the work my office has done in its oversight capacity.

In a very coordinated effort, the Department and Office of Inspector General (OIG) worked collaboratively to achieve a historic result with last year's national mortgage settlement of more than $25 billion—the largest consumer financial protection settlement in U.S. history. We are building on that success and have undertaken an initiative to review fraudulent loan originations made by some of the Nation's largest mortgage companies in the FHA program. These endeavors showcase the accomplishments that we are engaged in, not only with the Department, but also working closely with the U.S. Department of Justice (DOJ).

While I continue to support our activities relating to these reviews, I also endeavor to manage my limited resources to provide proper oversight of the many other programs and operations within the Department and its role in responding to Hurricane Sandy and other disasters. The following testimony highlights some of the more pressing issues facing the Department's administration of the FHA program, particularly in light of its increased role in the marketplace.

A HISTORY OF OIG CONCERNS AND FHA'S SLOW RESPONSE

HUD OIG has consistently expressed its concerns over the years about the level of oversight and risk taken on by FHA and the effect on its financial health. Unfortunately and for a number of reasons, FHA has been slow to respond to many of our recommendations and has only recently finally implemented some of them. For example, it has been noted that while seller-funded downpayment-assisted loans have been prohibited since the end of 2008, OIG has expressed its concern to FHA over the negative impact of seller-funded downpayments on FHA as far back as 1999. Loans using seller-funded downpayment assistance have proven to place a substantial stress on FHA's Mutual Mortgage Insurance (MMI) Fund.

OIG completed its first comprehensive analysis of seller-funded downpayments in March 2000, looking in depth at this and the associated program risks, as these loans increasingly began to consume a larger share of FHA loan originations. We concluded that HUD allowed nonprofit organizations to operate downpayment assistance programs that circumvented FHA requirements. The downpayment loan transactions did not meet the intent of FHA requirements in that the downpayment assistance was not a true gift from the nonprofit; sellers raised the sales price of properties to cover the cost of the seller-funded downpayment assistance, causing buyers to finance higher loan amounts; and default rates for buyers receiving downpayment assistance from nonprofit organizations were significantly higher than for other FHA loans. We recommended back then that HUD implement a proposed rule to eliminate seller-funded nonprofit downpayment programs.

Our long-term concerns and findings were later validated by several FHA-commissioned studies and by a U.S. Government Accounting Office (GAO) study in 2005, 6 years after we first raised concerns. However, FHA still resisted implementing our recommendation, in part because the change would have required the Department to go through the rulemaking process and there were concerns about whether FHA would prevail. More significantly, however, was FHA's concern at the time about the impact such a change would have on its market share. By 2006, the concentration of nonprofit downpayment assistance had approached 25 percent of FHA's new business portfolio, including purchase and refinance loans. FHA did not act to end the practice until 2007, and then legal challenges caused further delay. Ultimately, legislation to disallow the practice was enacted in 2008, too late to prevent the looming losses we are now seeing.

The legacy of this delayed inaction reverberates today as seller-funded downpayment-assisted loans continue to place significant stress on the MMI Fund. According to HUD's fiscal year 2012 report on the financial status of the fund, these loans account for only 4 percent of the outstanding portfolio but are 13 percent of all seriously delinquent loans. Over the life of the loans, seller-funded downpayment loans are expected to cost the MMI Fund more than $15 billion.

Similarly, in 2007, FHA was pressing for "reform" legislation that, among other things, would have raised loan limits and allowed FHA to insure loans with no borrower downpayment requirement. At the time, FHA's share of the mortgage market had fallen to less than 4 percent of the total market and less than 2 percent of the total dollars for mortgages originated in the United States. Indeed, with the ready availability of conventional subprime financing, FHA was perceived as becoming increasingly irrelevant, and the primary concern at FHA was to find ways to increase its market share. It focused more on marketing FHA loans than on instituting sound risk management and lender oversight.

HUD OIG testified in March 2007 and expressed its concern as to whether FHA was headed in the same direction as the subprime market with its seemingly continued deregulation and introduction of "riskier" products as part of its proposed reform. FHA seemed to have lost sight of the fact that since its inception, it has played a cyclical role in the housing market, sometimes gaining market share in times when it was needed to bolster the market and sometimes losing share when the conventional marketplace was addressing the constituency that FHA has always focused on: low- to moderate-income and first-time potential home buyers. However, this always remained true; whether in the conventional or Government mortgage programs, no loans should have been given if the purchaser was unable to pay back the loan.

Finally, in April 2009, when the effects of the economic crisis and collapse of the housing market were becoming more and more ominous, OIG testified before this subcommittee and expressed its concern about the impact of FHA's precedence-setting increased market share and HUD's ability to manage the increased workload with its limited and stagnant resources. FHA was also taking on new risk that needed to be managed. As an example, the Housing and Economic Recovery Act of 2008 authorized changes to FHA's Home Equity Conversion Mortgage (HECM) program that enabled more seniors to tap into their home's equity and obtain higher payouts. This office, at the time, raised concerns about HUD's ability to provide proper oversight as there was a critical need for more resources for FHA. Those resources were needed to:

—enhance its information technology (IT) systems;
—increase its personnel to meet escalating processing requirements;
—increase its training of personnel to maintain a workforce with the necessary skills to deal with the responsibility of this new portfolio;
—oversee the many contractors it maintained; and
—increase its oversight of all critical front-end issues, including such important areas as the appraisal, lender approval, and underwriting processes.

The HECM program was originally projected to be profitable for FHA but has turned out to be a substantial drain on the insurance fund. I will discuss the HECM program in more detail later in my testimony. While Secretary Donovan and FHA Commissioner Galante are proactive and supportive of OIG and its recommendations, I have to note, as described above, that FHA's reluctance over the years to more quickly deal with its looming issues has taken a toll, a toll we are only now beginning to understand. FHA has been trying to improve its financial position in recent years with legislative and regulatory proposals. But as we said years ago at the beginning of the subprime crisis, movement in the Department is more like turning an ocean liner than driving a fast boat through the tempests and currents of an ever-changing mortgage market.

A recent example of FHA's apparent inability to quickly react to changing conditions can be seen in its efforts to require lenders to indemnify HUD for serious and material violations of FHA origination requirements and for fraud and misrepresentation in connection with the origination of FHA loans. Historically, HUD has sought such indemnifications through agreement with the lenders. HUD already possesses the statutory authority to require such indemnifications for lenders participating it its Lender Insurance program and issued a proposed rule in October 2010 to, among other things, provide additional guidance on HUD's regulations implementing this authority. The rule was not finalized until January 2012, and the mortgagee letter to implement the change in policy was not issued until a month ago on April 10. According to the mortgagee letter, the revised indemnification policy is effective for all loans insured by Lender Insurance program lenders on or after that date. Thus, 2½ years have passed since the rule was proposed, and it remains to be seen whether this will be an effective tool in recovering losses since FHA's homeownership centers have yet to implement the change. To further exacerbate this situation, since 2010, HUD has been seeking statutory authority to require indemnifications from the remaining 70 percent of its direct endorsement lenders that do not participate in the Lender Insurance program.

Based on OIG's experience in dealing with FHA over the years, we remain concerned about HUD's resolve in taking the necessary actions going forward to protect the fund. HUD is often hesitant to take strong but needed actions against lenders because of its competing mandate to continue FHA's role in restoring the housing market and ensure the availability of mortgage credit and continued lender participation in the FHA program. Nevertheless, OIG has generally been supportive of FHA's initiatives to raise premiums and better manage its risk, including the establishment of its Office of Risk Management. Similarly, we strongly agree with HUD's position that FHA needs legislative changes to afford it greater flexibility to make changes to its policies and procedures as history has shown that it needs to be able to react more quickly to market changes and avoid losses that can accrue during a lengthy rulemaking process. In this light, my office is developing its own set of recommended legislative initiatives that we believe can further strengthen FHA's ability to mitigate risk and recover losses to the insurance fund and enhance OIG's ability to address fraud, waste, and abuse in the program. We will be vetting these proposals with FHA and the appropriate committees.

FINANCIAL HEALTH OF THE FHA MUTUAL MORTGAGE INSURANCE FUND

FHA's MMI Fund is the largest of its four mortgage insurance funds. The fund consists of a system of accounts used to manage FHA's single-family mortgage insurance programs. The Cranston-Gonzalez National Affordable Housing Act of 1990 mandated that the MMI Fund maintain a capital ratio of 2 percent from October 1, 2000, forward. The capital ratio is defined as the ratio of the fund's economic value to its insurance in force. The economic value essentially represents capital that exceeds the amount needed to cover anticipated losses. Clearly, when establishing this mandate, Congress voiced its concerns that some sort of cushion was important to maintain. The capital ratio has been below this required 2 percent level for the past 4 years, and each year has seen a further decline in the ratio to the point at which, based on the latest actuarial study in November of last year, the ratio has fallen below zero to negative 1.44 percent, which represents a negative economic value of $16.3 billion. The economic value of the forward portfolio was estimated at negative $13.5 billion and the HECM portfolio at negative $2.8 billion. These economic values represent capital reserve ratios of negative 1.28 percent and negative 3.58 percent, respectively.

Over the last several years, FHA has increased premiums and taken other steps to restore the financial health of the MMI Fund. Nevertheless, based upon FHA's deteriorating financial condition, in February 2013, GAO included FHA concerns in its "high risk" section relating to "Modernizing the U.S. Financial Regulatory System and Federal Role in Housing Finance." It was not FHA itself that was deemed a high risk but, rather, FHA as part of the larger high-risk concern over the Federal role in housing finance.

While we acknowledge the Department's actions to address the MMI Fund's finances, my office remains concerned about whether the actions are enough to make up for the losses FHA has sustained and to reach the required 2 percent level anytime in the near future. For example, FHA is now using credit scores as part of the eligibility requirements for FHA loans. As of October 2010, borrowers with credit scores below 500 are no longer eligible for FHA insurance, and the maximum loan-to-value ratio for borrowers with credit scores between 500 and 579 is 90 percent. At the time these changes were being proposed, we expressed our overall support

but also took the position that the changes did not go far enough and would likely have minimal impact on the MMI Fund in terms of bringing in additional premiums. While FHA enacted increased downpayment requirements for borrowers with credit scores below 580, we noted that loans for borrowers with credit scores below 580 were less than 1 percent of new activity. Moreover, the 580 credit score threshold is well into what is traditionally considered subprime territory in the conventional marketplace. A higher downpayment requirement at the appropriate credit score level would force borrowers to have more personal stake and financial exposure, which we believe would have a more meaningful impact in protecting the fund due to the larger volume of loans at higher credit score levels. The more a borrower is personally financially invested in a loan, the more unlikely he or she will be willing to give up on the investment.

As shown in the chart below from data we obtained from HUD's systems as of April 12, 2013, FHA has experienced high levels of claims in recent years compared with levels seen before the financial crisis. For purposes of illustration, the following chart reflects total FHA insurance claims from calendar years 2005 through 2008, the year that the current financial crisis began.

FHA INSURANCE CLAIMS

Year	Forward mortgage claims		Home equity conversion mortgage claims		Loss mitigation claims		Total	
	Claims	Amount paid	Claims	Amount paid	Claims	Amount paid	Claims	Amount paid
2005	68,455	$6,562,000,000	1,187	$87,000,000	75,407	$119,000,000	145,049	$6,768,000,000
2006	57,243	5,595,000,000	1,514	143,000,000	82,365	170,000,000	141,122	5,908,000,000
2007	54,556	5,629,000,000	2,257	256,000,000	84,758	150,000,000	141,571	6,035,000,000
2008	62,440	6,981,000,000	3,149	381,000,000	104,092	204,000,000	169,681	7,566,000,000
Total 2005 to 2008	242,694	24,767,000,000	8,107	867,000,000	346,622	643,000,000	597,423	26,277,000,000
2009	83,881	10,163,000,000	4,652	567,000,000	131,115	268,000,000	219,648	10,998,000,000
2010	119,830	15,654,000,000	5,681	559,000,000	208,876	411,000,000	334,387	16,624,000,000
2011	118,475	15,144,000,000	8,684	928,000,000	173,163	563,000,000	300,322	16,635,000,000
2012	155,266	20,245,000,000	14,207	1,432,000,000	142,551	660,000,000	312,024	22,337,000,000
Total 2009 to 2012	477,452	61,206,000,000	33,224	3,486,000,000	655,705	1,902,000,000	1,166,381	66,594,000,000
Grand total 2005 to 2012	720,146	85,973,000,000	41,331	4,353,000,000	1,002,327	2,545,000,000	1,763,804	92,871,000,000

As reflected in the charts above, the amount FHA paid in claims during the last 4 years was about 2½ times the amount paid during the preceding 4 years ($66.6 billion vs. $26.3 billion). The total amount of claim payments rose substantially in 2009 and has continued to increase.

Apart from the obvious financial implications, this situation creates a challenge for FHA, since the Prompt Payment Act requires HUD to pay the claim on a defaulted FHA-insured mortgage within 30 days and only then can it go back to the lender that underwrote the loan to recover losses incurred if it finds that the loan was ineligible for insurance. Thirty days is an insufficient amount of time for HUD to determine whether a loan was ineligible for insurance due to fraud or misrepresentation in the loan origination process. The result of this requirement places HUD in a "pay and chase" situation as our past audits have expressed concern over HUD's exposure when paying claims on loans that were not qualified for insurance. In addition, FHA has been resistant and slow in implementing a rigorous claim review process and to recover losses from lenders instead relying primarily on a strategy to focus efforts on loans that had not reached claim status. FHA only recently agreed with recommendations we made as far back as 2006 and again in 2011 to review all loans for which a claim was paid within the first 24 months, claims we define as high-risk claims. This matter takes on even greater importance in light of the significant amount of claims projected to be filed by lenders in the coming months and HUD's current limited capacity for reviewing submitted claims.

In addition to the unprecedented levels of claims noted above, FHA can expect to see a continuing influx of claims in the foreseeable future. The latest FHA-reported default rate (seriously delinquent loans) as of January 2013 stood at 9.49 percent. By comparison, the default rate in September 2008 was 6.91 percent. Based on our analysis of FHA data, the total unpaid balance of FHA single-family loans in default now exceeds $100 billion.

FHA LOANS IN DEFAULT (3 MONTHS OR MORE DELINQUENT) AS OF MARCH 31, 2013

Loans	Unpaid balance
724,173	$103,324,000,000

While FHA has taken a position that its current losses are primarily from loans made from 2007 to 2009, it continues to project that the current and future years' books of business will be profitable and make up for these past years' losses. However, what we have seen in the past 4 years is a troubling trend, whereby the point at which the MMI Fund is expected to reach its mandated capital level is pushed farther into the future. In the fiscal year 2009 independent actuarial study, it was predicted that by the end of fiscal year 2011, the MMI Fund's capital ratio would be 1.74 percent and that the MMI Fund would meet the 2 percent mandate sometime during fiscal year 2012. In the following 3 years, that forecast has changed dramatically as the capital ratio has continued to move in the wrong direction and is now negative. In addition, we now have concerns about the fiscal year 2010 and 2011 books of business as their profitability appears to be lower than projected and budgeted, as indicated and supported in the fiscal year 2014 Federal Credit Supplement to the Budget, although not as substantially different as the reestimates from the earlier years of 2007 to 2009.

Based on current projections, the capital ratio will not reach the 2 percent level until 2017, marking 8 years below the 2 percent threshold. Moreover, these estimates are heavily influenced by the pace at which housing prices will recover. Any additional slowdown in the housing market will increase FHA losses and further delay FHA's ability to meet its statutorily mandated 2 percent requirement. We continue to work with FHA to ensure that it is instituting sound risk management and lender oversight practices to avoid further exposure of the MMI Fund to losses.

My office also continues to stress that the FHA actuarial model is complicated and difficult to audit, use, and employ for risk management and strategic planning purposes. The model inhibits frequent updates as well as the ability to understand changes in specific programs or risk categories. Ultimately, its current design and objective are to be in statutory compliance and do not promote FHA's timely use of policy corrections based on products, cohorts, or risk classifications for current or interim benchmarking decisions. While we have recommended modeling at the midterm or quarterly, which we believe would provide FHA a better basis for timely policy corrections and assessing the actuarial value of the MMI Fund, the model cannot be easily changed because it is proprietary and owned by the actuarial firm. I continue to have discussions with the FHA Commissioner regarding these issues.

With regard to one recent change in the modeling, the 2012 actuarial study applied a stochastic method to estimate the net present value of future cash flows. This was done to a large extent because of recommendations by OIG and GAO, recommendations that had been made for some years before 2012.

HOME EQUITY CONVERSION MORTGAGE PROGRAM

The FHA HECM program is the only Government-insured reverse mortgage program. The HECM program guarantees that the lender will meet its payment obligations to the homeowner, limits the borrower's loan origination costs, and insures full repayment of the loan balance to the lender up to the maximum claim amount; that is, the lesser of the appraised value at origination or the national HECM loan limit of $625,500. HECM insurance endorsements in fiscal year 2012 were down by 25 percent from fiscal year 2011 levels to 54,591. Fiscal year 2012 marks the third consecutive year in which HECM volume has declined. Yet, with a declining HECM demand, FHA asserts that the fiscal year 2014 budget request for $943 million is largely due to the existing HECM portfolio. This product, particularly as it has been structured to date, is sensitive to home prices and economic conditions. This condition has resulted in a negative value of $5.248 billion and a disproportionately negative impact to the MMI Fund from the HECM program.

FHA is proposing, either through the granting of the legislative authority described below or via the much longer rule-making process, the following measures:

—Limiting the draw at origination to mandatory obligations;
—Addressing the issue of non-borrowing spouse language in the fiscal year 2015 budget;
—Performing a financial assessment of borrowers as a basis for loan approval and determining the suitability of various HECM products to protect consumers from acquiring loans not fit for their situation; and
—Establishing a tax and insurance set-aside to ensure that sufficient equity or an annuity is available to pay taxes and insurance on the mortgaged property so that defaults resulting from nonpayment of taxes and insurance can be avoided.

While OIG supports these proposed changes, it continues to raise concerns about FHA's belated actions. Since 2008, OIG has been proposing similar changes to the HECM program based on results of its audit and investigative work. The four OIG reports discussed below identified problems with reporting borrowers' deaths, payment of required property taxes and insurance, reliability of financial data, and compliance with the HECM residency requirement.

A 2008 audit found that HUD did not ensure that FHA lenders reported HECM borrowers' deaths in accordance with Federal requirements. HUD could not be assured that FHA lenders appropriately met HUD's time requirement for initiating the foreclosure process or recording the deeds-in-lieu to take possession of the property, which impacted the amount of the lender's insurance claims.

In an internal audit issued in August 2010, we determined that HUD had not tracked almost 13,000 defaulted HECM loans with maximum claim amounts of potentially more than $2.5 billion. The audit found that an increasing number of borrowers had not paid required taxes or homeowner's insurance premiums, thus placing the loan in default. We noted that HUD granted foreclosure deferrals routinely on these defaulted loans but it had no formal procedures to do so. HUD's informal foreclosure deferral policy had a negative effect on the universe of HECM loans and loan servicers. After canceling its informal policy, HUD did not issue guidance to servicers advising them of what action to take regarding defaulted loans. Thus, servicers continued to service the loan and paid the taxes and insurance for the borrowers without notifying HUD. As a result, four servicers contacted were holding almost 13,000 defaulted loans with a maximum claim amount of more than $2.5 billion, and two of the four servicers said they were awaiting HUD guidance on how to handle them.

The servicers had also paid approximately $35 million in taxes and insurance on these loans. HUD was unable to identify the deferred or defaulted loans in its system and did not track the number of borrowers who were unable to pay their taxes or insurance premiums. Since unreported defaulted loans were only obtained from 4 of a total of 16 HECM servicers nationwide, more defaulted loans may have existed. Since HUD could not track these loans, it did not know the potential claim amount in the event of foreclosure of about 7,700 loans of which HUD was aware and about 13,000 loans of which it was not aware and could lose an additional estimated $1.4 billion upon the sale of the properties.

In June 2011, we issued a report on HECM loan payments made after the death of the borrower. Our results indicated a few instances in which unscheduled ad-

vance payments were made after the death of the borrower, which resulted in claims paid by HUD, although we did not believe this was a systemic problem. In most cases, we found that scheduled payments were not actually made after the death of the borrower but were incorrectly recorded in HUD's Insurance Accounting Collection System by the lenders. More noteworthy was the fact that loan proceeds from the sale of property and claims paid by HUD were not credited to the HECM loan balances in a timely manner, resulting in inaccurate information being reported to HUD, causing unreliable financial data to be used by HUD. This evaluation also noted instances in which HECM loan servicing files contained indications of suspicious or potentially fraudulent transactions; however, there was no evidence that such matters were referred to HUD for further action. Lender officials stated that HUD's guidance in this area was too broad and that specific fraud indicators should be included in any future guidance.

Finally, in an internal audit issued in December 2012, we found that HUD policies did not always ensure that borrowers complied with program residency requirements under the HECM program. A review of 174 borrowers indicated that 37, or 21 percent, were not living in the property associated with the loan as required by the residency requirement to participate in the HECM program. These 37 loans were ineligible and should have been declared in default and due and payable to reduce the potential risk of loss of about $525,000 to HUD's insurance fund. These 37 loans had already been advanced $5.8 million, with the $525,000 remaining to be disbursed, although the borrowers were not living in the home.

In addition to the above-mentioned audits and reviews, the OIG Office of Investigation completed a number of criminal cases in which the criminals used elderly straw buyers to obtain HECM loans.

Due to the negative value of the MMI Fund, OIG plans to work closely with FHA in obtaining its proposed changes to the HECM program and in furthering other OIG-recommended changes to the program.

OIG EFFORTS TO RECOVER LOSSES AND ADDRESS FRAUD AGAINST THE MMI FUND

As noted earlier, FHA has taken various measures to restore the financial health of the MMI Fund. OIG has also played an active role in this regard by aggressively pursuing and recovering losses from lenders that were engaged in questionable and often fraudulent underwriting of FHA loans. In the early part of 2011, OIG, in partnership with HUD and DOJ, initiated a number of mortgage lender reviews, whereby statistical samples of claims, defaults, and all other loans were drawn to determine the accuracy and due diligence of the underwriters of FHA loans by a number of the Nation's largest lenders. The reviews completed to date have resulted in a total of $1.24 billion in civil settlements for alleged violations of the False Claims Act and for failure to fully comply with FHA requirements. Some of these settlements involved some of America's largest lending institutions.

The loan-level reviews OIG has been conducting and which have resulted in large civil fraud settlements with major lenders are on the order of what we would expect HUD to be doing for itself as an inherent program responsibility. Examples of these activities include (1) reviews of seriously delinquent loans before claim submission and terminated loans upon claim submission for origination and misrepresentations and (2) claim mitigation in which claims are reviewed for documentation issues, violations of servicing requirements, and potential collateral-related defects. These examples are normal and expected practices in the private mortgage insurance sector. This issue relates to earlier comments about FHA's resistance to and slowness in implementing a rigorous claims review process and going back to the lenders to recover losses instead relying primarily on a strategy to focus efforts on loans that had not reached claim status.

OIG continues to aggressively review lender origination and underwriting practices as part of its ongoing oversight efforts in a housing market that for years was reckless about lending money. Imprudent business practices became a pervasive problem, and now those loans underwritten during that time are having a significant negative impact on the MMI Fund. The result has been a dramatic increase in mortgage delinquencies, defaults, and foreclosures. Too often lenders ignored FHA requirements to get a loan approved. Borrowers were sold unsustainable mortgages, sometimes unsuspectingly and sometimes with their full knowledge, which encouraged widespread indifference to the ability of many consumers to repay their loans. Some lenders thought they could make money on a loan even if the consumer could not pay back that loan, by either banking on rising housing prices or passing along the mortgage into the secondary market.

Adding to this problem was a 100 percent insurance guarantee by FHA, which created no real financial exposure to these losses on the part of the lender and in

some cases, no real incentive to comply with the requirements of participation. The practices of many lenders were not just the result of poor procedures but involved real infractions of good business stewardship and proper behavior when participating in the FHA program. A failure by FHA to create a strong and meaningful oversight atmosphere creates an environment that virtually invites the abuses we have seen in our lender reviews. Quite simply, lenders are responsible for complying with all applicable HUD regulations and in turn are protected against default by FHA's insurance program for doing so. To provide some context, mortgage fraud is second only to healthcare fraud on DOJ's list of investigative and prosecution priorities.

Indeed, our reviews have shown high percentages of loans containing significant deficiencies, loans that clearly should not have been underwritten. Our reviews look for major noncompliance and a failure to follow the rules that have long been established. We are not looking at close-call interpretations of underwriting but wholesale abandonment of the core requirements that leads to huge default and claim rates for FHA-insured mortgages.

By way of example, my office is currently reviewing one lender's claims to FHA using a statistically representative sample of all claims it made in a given period. The statistical sample pool was 85 loans. While these results are preliminary, 91 percent of those loans had significant deficiencies, 77 of 85 loans. Of those loans with significant deficiencies, 87 percent, or 67 loans, had material, incurable violations of HUD underwriting requirements and standards. These violations were essentially incurable by the lender and exposed the FHA insurance fund to an unacceptable level of risk and claims that it did not agree to take on under the insurance program.

In another ongoing example, we conducted a review of a statistically representative sample of claims at another lender. Again, the statistical sample pool was 85 loans. Again citing preliminary results, the percentage of those loans that had significant deficiencies was 100 percent. Of those 85 loans, 78 loans (92 percent) had material, incurable violations of HUD underwriting requirements and standards. We expanded our review to defaults for this lender using a statistically representative sample, which resulted in a sample pool of 110 loans. Our preliminary review found that every one of those loans—110 of 110 (100 percent)—had significant deficiencies. Of those 110 loans, 95 (86 percent) had material, incurable violations of HUD underwriting requirements and standards that also exposed the FHA insurance fund to an unacceptable level of risk and claims that it did not agree to take on under the insurance program.

To be clear, we are not talking about minor deficiencies. These reviews are exposing violations of HUD's underwriting requirements and standards, which constitute substantive material violations. Therefore, the underwriter's certifications to HUD are false, and those loans can form the basis of a False Claims Act case. The types of substantive material violations that we are uncovering amount to violating fundamental requirements of insuring a loan, which include failing to document a borrower's income and employment, failing to evaluate all recurring debt obligations that FHA requires an underwriter to consider, and failing to verify that the borrowers possess the necessary funds to close the loan.

It is OIG's contention that if lenders follow a well-established quality control plan, exercise due diligence and good industry practices, follow required procedures, and submit documented conforming loans based on a reasonable good faith determination of a consumer's ability to repay the loan, their lending behavior does not have to be unduly constrained nor should they overly restrict making responsible loans.

INVENTORY OF FORECLOSED-UPON SINGLE-FAMILY PROPERTIES

In prior years, we have reported on various concerns relating to HUD's procurement and contract management, including HUD's IT infrastructure contracts and HUD's transition to the third generation of its management and marketing contracts that are used to manage and dispose of its extensive inventory of foreclosed-upon single-family properties, known as real estate-owned (REO) properties. HUD continues to be challenged by its overreliance on contractors in general and its ability to allocate sufficient resources to adequately oversee its contractor workforce. Since taking this position, I have made it a priority to take a closer look at the Department's procurement and contract management processes to ensure that waste, fraud, or mismanagement can be identified at its earliest occasion.

HUD's inventory of REO properties had increased dramatically from about 45,700 properties in March 2010 to nearly 69,000 at the end of March 2011. The inventory declined after HUD restructured its management and marketing contracts and as of January 2013, stood at about 39,000. While the decline from the historically high

levels of 2 years ago is a positive trend, the percentage loss on the sale of these properties remains high but has begun to decline. Still, during fiscal year 2012, losses averaged about 62 percent of HUD's acquisition cost. In contrast, HUD's average loss during 2007 was about 40 percent. HUD's oversight of these management and marketing contractors will be critical to ensure that returns on property sales are maximized, thereby reducing further losses to the FHA insurance fund. During fiscal year 2012 alone, FHA's losses on REO property sales exceeded $9.2 billion.

We recently completed an audit of HUD's oversight of its REO Management and Marketing program to determine whether HUD's policies and procedures provided for efficient and effective oversight of asset managers and field service managers under the program. We determined that HUD did not have adequate procedures in place to ensure consistent and adequate enforcement of asset and field service manager contracts. Specifically, (1) list prices were not always reduced according to the marketing plans, (2) bids were approved that did not meet HUD's flexible threshold, (3) bids were rejected that met the marketing plan thresholds, (4) bids that met applicable thresholds were not always counteroffered or forwarded to the government technical representative for approval, and (5) properties were not assigned to field service managers based on performance even when HUD identified performance issues.

FINANCIAL MANAGEMENT SYSTEMS

Since fiscal year 1991, OIG has annually reported on the Department's lack of an integrated financial management system, including the need to enhance FHA's management controls over its portfolio of integrated insurance and financial systems. We continue to report that HUD's financial management systems have not substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996, which encourages agencies to have systems that generate timely, accurate, and useful information with which to make informed decisions and to ensure accountability on an ongoing basis. This situation could negatively impact HUD's ability to perform required financial management functions and efficiently manage financial operations of the agency, notably FHA, which could translate to lost opportunities for achieving mission goals and improving mission performance.

In August 2009, FHA completed the Information Technology Strategy and Improvement Plan, which identified FHA's priorities for IT transformation. The plan identified 25 initiatives to address specific FHA lines of business needs. Initiatives were prioritized, with the top five being single-family related.

To date, FHA has completed a few of the goals but not all due to a lack of funding. FHA is working on acquiring risk management tools but has only made substantive progress with its initial objective. During our upcoming audit of FHA's fiscal year 2013 financial statements, we will be reviewing FHA's progress in implementing this plan.

The plan also called for FHA to create a program management office to facilitate coordination and communication, track and report progress, provide support to managers, and support organizational change management activities. This office was put into place almost immediately after the funding became available and is being led by a long-term IT staffer.

Since fiscal year 2009, the FHA Transformation Initiative's focus has been on improving its counterparty management by automating the certification processes and acquiring risk management tools to monitor lender activity. In conjunction with these development activities, FHA has procured the IT infrastructure needed for its planned improvements to multifamily underwriting and single-family insurance program support.

Our biggest remaining IT concern is FHA's ability to replace the antiquated infrastructure on which many FHA single-family applications reside in a timely manner. For example, FHA's general ledger is an Oracle system, which has to interface with multiple older COBOL systems. None of the older legacy COBOL systems have received sufficient funding to be replaced, yet they are expensive to maintain. Due to a lack of funding, interfaces and the related systems are still in place. While there may have been some programming changes, we understand that these were basically patches or temporary fixes to implement specific policy changes.

Overall, it appears that funding constraints have reduced the FHA Information System Transformation project to a continuation of high-level planning without a defined timetable to complete the new application systems and to phase out and deactivate the current outdated systems. These delays bring about another concern: the ability to maintain the antiquated infrastructure on which some of the HUD and FHA applications reside while the Transformation Initiative is underway. Workloads have dramatically increased and are processing on systems that are 15 to 30

years old. These legacy systems must be maintained to effectively support the current market conditions and volume of activity. However, the use of aging hardware and software can result in poor performance and high maintenance costs. If the IT infrastructure is not modernized in a timely manner, it will become increasingly difficult and expensive to maintain operations, make legislatively required system modifications, and maintain interfaces to other IT systems.

RECENT OIG INVESTIGATIVE AND AUDIT RESULTS

As mentioned earlier, HUD OIG conducts criminal investigations involving allegations of fraud against HUD's programs, including theft, embezzlement, and false statements by program participants and recipients. The investigations may be generated from leads provided by HUD program staff, the mortgage industry, and other sources and may be conducted jointly with Federal, State, and local law enforcement agencies. Our long-term investigative experience in the area of mortgage fraud schemes has given us proficiency and extensive knowledge to address these issues. Many "traditional" fraud schemes continue to affect FHA, such as appraisal fraud, identity theft, loan origination fraud, rescue and foreclosure fraud, and fraud in the HECM program.

The following represent some examples of recent investigations:

—A former mortgage company loan officer was sentenced to 54 months incarceration and 3 years supervised release and was ordered to pay more than $9.2 million in restitution to FHA. He conspired with others to create and submit false and fraudulent FHA mortgage loan applications and accompanying documents to a lender on behalf of unqualified borrowers. He created false pay stubs, Federal tax forms, verification of employment forms, explanation letters, and other documents to ensure that otherwise unqualified borrowers could obtain FHA-insured loans. He enticed borrowers to obtain an FHA mortgage by paying them an incentive of up to $20,000 per loan. More than 75 FHA loans were approved using this false information with more than 31 claims identified. The loss to FHA was estimated at $6.5 million. The mortgage company was terminated as an FHA-approved lender, and the loan officer and others were suspended pending debarment action. Our investigation is continuing.

—A former senior vice president and loan officer, a former senior vice president of residential lending, a former underwriter, and a former loan processor pled guilty to conspiracy to submit false statements in loan applications and submitting false statements in loan applications to FHA. The defendants were involved in originating and approving FHA-insured loans and conventional loans that contained fraudulent information. The case involved approximately 1,900 FHA loans. To date, FHA has incurred losses in excess of $36 million after paying claims on and disposing of 234 foreclosed-upon properties. An additional 393 loans, with an unpaid balance in excess of $92 million, have been identified as delinquent or in various stages of the foreclosure process. The bank was closed by the Federal Deposit Insurance Corporation and is no longer in business. The above-noted defendants have been recommended for suspension and debarment action, and our investigation continues.

—Two former principals of a HUD-approved mortgage company pled guilty to one count of racketeering following their indictment in June 2011. The defendants were involved in a complex scheme to defraud FHA through a series of false statements on at least 65 FHA loans totaling in excess of $10 million. The fraudulent acts included the use of straw purchasers, phony employers, bogus bank statements and pay stubs, forged college transcripts, counterfeit court documents, and phony downpayment gifts. Additionally, the defendants profited from the scheme by recording junior mortgages that were payable to business entities or associates from the loan proceeds. The mortgage company's FHA approval was terminated, and the company's principals were suspended pending their debarment.

OIG's Joint Civil Fraud Division conducts reviews of FHA-approved lenders. The reviews continue to disclose serious deficiencies in the originating and underwriting of FHA mortgages. As noted earlier, many of these reviews were conducted in support of our efforts to recover losses. These reviews and our audit work focus on areas in which HUD can improve its oversight and management of its single-family mortgage insurance programs. For example, as noted earlier, OIG reviewed the foreclosure practices for five of the largest FHA mortgage servicers (Ally Financial, Incorporated; Bank of America; CitiMortgage; JPMorgan Chase; and Wells Fargo Bank) due to reported allegations made in the fall of 2010 that national mortgage servicing lenders were engaged in widespread questionable foreclosure practices involving the use of foreclosure "mills" and a practice known as "robosigning."

In September 2012, we summarized the results of the five reviews, which were used by DOJ and 49 State attorneys general to negotiate a settlement with the five lenders totaling $25 billion. The Federal settlement payment amount of more than $684 million would be used for (1) losses incurred to FHA's capital reserve account and the Veterans Housing Benefit Program Fund or as otherwise directed by the U.S. Department of Veterans Affairs and the U.S. Department of Agriculture's Rural Housing Service and (2) the resolution of qui tam actions.

As result of this work, OIG recommended that HUD:

—determine the changes needed to FHA's servicing and foreclosure policies based on the consent judgments and ensure that the servicers incorporate the necessary changes into their procedures for servicing FHA-insured loans;

—ensure that the servicers establish or implement adequate procedures and controls to address the control deficiencies cited in the five issued memorandums, including but not limited to the withholding of claims for insurance benefits and the retention of appropriate legal documentation supporting the appropriateness of the foreclosure for all FHA-insured properties for the life of the loans; and

—pursue appropriate administrative sanctions against attorneys who may have violated professional obligations related to the foreclosure of FHA-insured properties.

Finally, the Department continues to face challenges in ensuring that its single-family programs benefit eligible participants and do not pay improper claims. In a recent audit of FHA's Preforeclosure Sale Program, OIG identified that, based on a statistical projection FHA paid an estimated $1.06 billion in claims for 11,693 preforeclosure (short) sales that did not meet the criteria for participation in the program. This condition occurred because HUD did not have adequate controls to enforce the program requirements and requirements were not well written. Specifically, FHA relied entirely on the lenders in approving borrowers for the program and did not provide lenders with detailed instructions for reviewing borrower assets. As a result, the FHA insurance fund may have taken unnecessary losses while borrowers, who may otherwise have been able to sustain their obligations, were inappropriately relieved of their debt using FHA insurance fund reserves. FHA has agreed that existing program policy and lender execution against that policy are inconsistent. In response to our recommendations to improve alignment and ensure that the long-term interest of the FHA insurance fund are met, FHA is working toward (1) introducing a streamlined program approval policy based on loan characteristics and a borrower credit profile and (2) specifying income documentation requirements for the income deficit test that must be met for borrowers who do not meet the streamlined requirements.

CONCLUSION

The Department's role has greatly increased, while staffing has decreased, over the last decade as it has had to deal with unanticipated disasters and economic crises in addition to its other missions, which have increased its visibility and reaffirmed its vital role in providing services that impact the lives of our citizens. The Department can do more to address the internal control and program weaknesses in FHA. My office is strongly committed to working with the Department and Congress to ensure that these important programs operate efficiently and effectively and as intended for the benefit of the American taxpayers now and into the future. I look forward to working with the Department and this subcommittee to accomplish some of these goals.

Senator MURRAY. Thank you very much, both of you.

MUTUAL MORTGAGE INSURANCE FUND

Commissioner Galante, let me start with you. The budget states that $943 million may be needed to cover losses in FHA's MMI Fund in fiscal year 2013. This follows on the most recent actuarial report showing that the capital reserve account is expected to go negative.

Can you explain the process HUD goes through to come up with these estimates, including any changes to this year's model?

Ms. GALANTE. Certainly. Thank you, Chairman, for the question. To be clear, FHA goes through two different processes. The independent actuarial that is done and was released in November 2012

looks at the 30-year projections of what is necessary for projected losses under the fund under economic conditions that they are projecting through independent indices.

The President's budget takes a look at the same kinds of conditions, but uses their own analysis of interest rates, house prices, and what-not in terms of how the projection of the budget re-estimate is made. So they're similar processes, but they're two different processes.

With respect to the actuarial, I would just say we made a number of changes, or the actuarial made a number of changes this year, including going to what's called stochastic modeling, which models a variety of economic paths more clearly, more distinctly than it had done in the past, as well as how it looked at the defaulted loans and how they would transition from performing to non-performing and how that works—so a number of important changes in the model.

Senator MURRAY. Mr. Montoya, you raised concerns about the 2010 and 2011 books of business. Can you tell us what your specific concerns are?

Mr. MONTOYA. Our concerns are that they aren't appearing to be as profitable as we think FHA has sort of rested their future estimates on. While they're not far off from some of the estimates FHA has, it's our feeling they may be weighing too much on how successful they will be.

Senator MURRAY. Weighing too much?

Mr. MONTOYA. Yes, ma'am, that they would be less successful than they anticipate to be.

Senator MURRAY. Commissioner Galante, do you want to respond to that?

Ms. GALANTE. Certainly. The budget re-estimate process, as part of the President's budget, every year re-estimates every cohort of business that FHA does and determines whether the estimates that had been done the year before, based on current economic conditions, would still hold. So the Inspector General is correct that for 2010 and 2011, the re-estimate this year was that those books of business were not as profitable as they had been anticipated to be. But they certainly still were very profitable and successful books of business.

On the flip side, the 2012 cohort was demonstrated as actually adding value to the fund that had been unanticipated. So this is really the result of the budget estimation process requiring long-term projections in terms of looking at the economic success of each of the cohort years of business.

Senator MURRAY. We already talked about HECM loans, that they continue to represent a disproportionate share of losses to the fund. HECM loans can be a great resource for seniors who want to stay in their homes, but there are a lot of problems with the current product.

HECM HIGH DEFAULT RATE

Commissioner Galante, I wanted you to explain to us why the HECM loans are experiencing such high default rates and what reforms you are proposing to reduce the risk on that.

Ms. GALANTE. Yes, thank you. There are a couple of reasons for the challenge with the HECM program. First, I would say that like the forward book of business, the HECM loans are suffering from projections of a decrease in home prices. And that affects—particularly for the HECM loans, long-term house price projections definitely affect the reverse mortgage program projections more severely than they would in a forward mortgage because they are for a longer period of time. So that is one reason.

The other reason is that, frankly, the way they have been underwritten is based on the longevity of the life of the individual borrower, and there is improvement in longevity. So some folks are outliving, so to speak, the original actuarial projections there.

Those things are magnified by other challenges that I would say are in the program design today that we really want to get to the heart of fixing. One is that the way the program is designed today encourages people to take a large amount of the mortgage proceeds up front, and then sometimes what happens is they don't have enough over the life of the mortgage to continue to pay, say, their property taxes and insurance liability and other challenges of that nature.

So what we are really asking for, I would put in three buckets. One is to be able to immediately, through mortgagee letters, as opposed to going through 1½ years plus rulemaking process, make some immediate changes on the principal amount that borrowers are allowed to take out up front.

Senator MURRAY. And you can do that without legislation?

Ms. GALANTE. We can do that without legislation, but we would have to go through rulemaking. Without you giving us authority to do it by mortgagee letter, we would have to go through a longer process to get there. But, statutorily, we could do it.

Second—and I know I'm taking a bit of time here. But, second, I would say that demanding that we do a financial assessment of the borrowers and their ability to pay the taxes and insurance on an ongoing basis—right now, we are encouraging lenders to look at that, but it is not a requirement of the program. So that's an important measure that we would want to do, and, also, requiring set-asides for taxes and insurance, for example, for those owners who really need that, to be sure that they can pay their ongoing charges.

Lastly, I would say there is a challenge in the current environment where non-borrower spouses are not being—if they're not on the mortgage loan, they're not getting the protection of being on the mortgage loan and being able to——

Senator MURRAY. In my understanding, sometimes that's done because of the age of the spouse.

HOME EQUITY CONVERSION MORTGAGE COUNSELING

Ms. GALANTE. Yes, sometimes—you know, what we believe is happening is by the age of the spouse, they are not eligible to be part of the HECM mortgage. But what we want to make sure of is that we have rules going forward where they're part of the mortgage and, therefore, get the protection. But their age is also taken into consideration in the underwriting so that we are actuarially pricing this according to the life of the borrowers.

And so there's some confusion perhaps in the market or disagreement about whether that provision—whether we can do that correctly today based on statute. We have taken the position for the past 25 years that we can. But there's been some challenge to that, and we would like legislation to clarify the intent that we can continue to do that.

Senator MURRAY. Mr. Montoya, what do you think about those proposed reforms?

Mr. MONTOYA. We certainly support FHA's proposals. One of the concerns that we have seen through a lot of the failings with these loans and, quite frankly, from a lot of the fraud aspects that we see is that we don't believe that counselors are doing as good a job as they should be in really identifying for these seniors the loan they're getting into and really what they're getting into.

They're not really instructed on how much and how expensive it would be, sometimes not instructed on the taxes and insurance and homeowner's fees that will need to be paid, sometimes two or three times more than what they make in a monthly income. Many times, they don't even see these homes before they get into them, if they're buying a new home under the HECM program, to make sure they fit their needs as they begin to age.

So there's a lot of other things that we think we can work with FHA to do to tighten up just sort of the knowledge that these seniors need before they take this product.

Senator MURRAY. My time—I've gone way over.

So, Senator Collins, I'll turn to you.

Senator COLLINS. Thank you, Madam Chairman. Let me follow up on the question on reverse mortgages.

Commissioner, you referred very briefly to an issue that I want to ask you a little more about. And that is some seniors with reverse mortgages insured through the HECM program have failed to pay their property taxes and/or their homeowner's insurance premiums, which technically, at least, puts them in default on their mortgages.

In order to avoid this problem, could HUD require lenders to set up an escrow account where, as with forward mortgages, property taxes, and insurance are paid out of that account and then added to the mortgage balance? Many of us have escrow accounts built into our mortgages to make sure we do have the funds available for property taxes and insurance when they come due.

And second and related to that—because you did refer to doing something in that area, but I'm unclear exactly what—are you in need of legislative authority in order to avoid this very lengthy rulemaking that the Inspector General has referred to in order to implement such a change? So, first of all, are you considering an escrow account type requirement, and, second, if so, can you do it administratively quickly?

Ms. GALANTE. Yes. In order to do it administratively quickly through a mortgagee letter, we need authority from you to do it by a mortgagee letter, as opposed to going through the full rulemaking process, because the current regulations for the HECM program do not permit us to do this.

Having said that, I do want to be clear. We would really like that authority, but I do want to be clear, though, that we have been

working on this with whatever tools we can in the interim. We actually issued a mortgagee letter asking lenders to go out and notify borrowers, for example, who were in default on their taxes and insurance, and work with them for repayment plans. We did that about 1 year ago, and it is being successful.

HOME EQUITY CONVERSION MORTGAGE ESCROW ACCOUNTS

That isn't going to turn the tide for the future of really ensuring that up front. We are setting aside the funds so that we know that there is an escrow there for those homeowners to pay those property taxes and insurance charges—and also to evaluate the borrower on their ability once they take out this mortgage to continue to be able to pay those taxes and insurance. In order to do that, we need to change the regulation, and that means either going through a 1½ years long process, or, if you give us the authority to do it, by mortgagee letter, we could do it more quickly.

Senator COLLINS. Do you think it's a good idea in concept?

Ms. GALANTE. Absolutely. If I didn't make that clear, we think it's a very necessary component to the program.

Senator COLLINS. Why is your rulemaking so slow? I assume you follow the APA the way any other agency would.

Ms. GALANTE. Yes. Let me just be clear: We are working on guidance today so that if we need to go through the rulemaking process, we will try to do it as quickly as we possibly can. The proposing of the notice, getting comments back, evaluating those comments, putting back out—you know, hopefully, you don't get any major controversy; if you get major controversy, then you may have to re-propose—it just takes a significant amount of time to do that analysis and back and forth.

Senator COLLINS. I guess what I don't understand—if I were in your shoes—and you've identified this problem, and you've identified something you could do about it—I'd be in the midst of rulemaking right now. I wouldn't wait. I would still ask us for authority for you to do it in a more expeditious manner. But I wouldn't be waiting to do rulemaking. And it seems to me that a point that the Inspector General has made in his reports is this slowness of response by FHA.

Ms. GALANTE. Yes. To be clear, we did spend the time to immediately—so 1 year ago, we put out the guidance——

Senator COLLINS. But guidance isn't rulemaking, and I'm not a fan of agencies putting out guidance, because it means that it doesn't go through a public comment process.

Ms. GALANTE. Right. We did that in January of last year, though, just to ensure that we could deal with the current situation that we have with people who are already in current defaults.

Senator COLLINS. Excuse me for interrupting. But if in January of last year you had started the rulemaking on this, you would be probably done now or close to it.

Ms. GALANTE. Yes. So, as I said, we are in that process of getting ready to put out a rulemaking. We're in the rulemaking process. We just haven't actually put out the proposed rule yet.

Senator COLLINS. Well, I've got two other issues I want to turn to. But I guess what I would say to you is it seems to me you should have begun that rulemaking last January. It's now June.

That's 1½ years. You'd be done. And I just think, even though it's faster if you get the mortgagee letter approach approved by us, you know what the legislative processes can be like. It's not pretty these days.

I just would encourage you that if you think you have the answer to something, don't wait. Start the rulemaking. You don't have to necessarily go—you may be able to short circuit it through legislation, but don't wait. That was 1½ years ago.

Ms. GALANTE. We are working on that.

Senator COLLINS. Let me turn to another question. You informed us today that FHA has now used 75 percent of the commitment authority for the general insurance and special risk insurance fund, and current projections indicate that without additional commitment authority this year, FHA will be required to suspend insurance activity in mid August. This is very troubling to me.

As you know, the chairman and I have been supportive of increasing the commitment authority for this important program. We would have liked to have gotten it in along with our bill, into the continuing resolution that was passed. It's important because it provides mortgage insurance for the construction of multifamily housing, hospitals, healthcare facilities.

How will FHA manage the remaining commitment authority, and what will the effect be if the fund is forced to suspend activity because you've run out of commitment authority?

COMMITMENT AUTHORITY

Ms. GALANTE. Yes, thank you, and thank you for your support for the additional authority. I would say a couple of things. First and foremost, now that we have hit the 75 percent, any commitments that are issued need to come into headquarters before they're issued so that we can literally—the first and foremost concern we have is to be sure that we're monitoring daily each commitment that's issued and now allowing a commitment to be issued if we don't have the authority. So, particularly, as we get closer and closer to the end of the fiscal year or to exhausting 100 percent of the authority, we need to pay attention to that.

We have also had a number of conversations with industry about how to prioritize if we don't get additional commitment authority, you know, the best ways to prioritize the remaining——

Senator MURRAY. If I could just—how many projects do you have in the pipeline right now?

Ms. GALANTE. I don't know the exact number of projects, but we have in the pipeline more than the amount of authority we have left for the balance of the year. So if we need to stop issuing commitments in mid August, really, what we're talking about is new construction projects that were ready to close or soon to be ready to close and get under construction. We'd lose those jobs. We'd lose that economic activity.

For properties that are being refinanced, you know, and are rehabilitating properties, they won't get their rehab done. They might be refinancing to take advantage of lower interest rates and, therefore, really be in a position to be as financially sound as possible going forward and protect the property. So those activities would

need to be delayed. This really is a problem of delay if we run out of authority between now and the end of the year.

Senator COLLINS. Thank you, Madam Chairman. That is of great concern.

Senator MURRAY. Senator Boozman.

Senator BOOZMAN. Thank you, Madam Chair.

Ms. Galante, I have the same problems as the Senator from Maine with the guidance issues, as far as not going forward and going through the process, where you have guidance which essentially has the same force of a rule, but the process isn't done. You said that you hadn't done it yet. I guess my question is when is yet? When do you expect a rule to be forthcoming?

Ms. GALANTE. We're in a position that we are driving as hard as we can to get a proposed rule out by July or August of this year, because, again, we really need to get it in place as soon as possible so that we can continue to operate the program.

Senator BOOZMAN. So July or August is a reasonable expectation of the——

Ms. GALANTE. That's the proposed rule, and then there's the back and forth process, yes.

Senator BOOZMAN. Let me ask you this. Last summer, the FHFA released a public request for comment on proposals to use a municipality's power of eminent domain to seize mortgage loans. At that time, the FHFA expressed concerns with such proposals and said that action may be necessary on its part to avoid a risk to safe and sound operations at its regulated entities and to avoid taxpayers' expense.

What is your view on the proposed use of eminent domain in that regard?

EMINENT DOMAIN

Ms. GALANTE. Yes, thank you for the question. We certainly think it's premature for FHA to issue any guidance on this. There are a few places that have adopted the policy, but not actually implemented it. We believe the eminent domain process at its core is a local issue, and how localities use their eminent domain is something that is subject to a lot of local review.

We also believe that the idea of it being used on mortgages is trying to get at an important issue of people's inability to refinance their mortgages that are in private label securities, and I think that's the primary driver behind that concept. And we do think that there are other ways of working to get more people refinanced who are under water, and we certainly look forward to continuing to work with Congress on some of those solutions.

Senator BOOZMAN. So if they are refinanced under that system, they are done into FHA-backed loans, potentially?

Ms. GALANTE. Again, you know, if a community gets to a point where they are through all of the significant issues that are still to go to work out whether this is a viable concept, if all of that happens, then FHA will obviously need to be in a position to look at its approach to those loans. We just think it's premature in terms of how those proposals are being implemented.

Senator BOOZMAN. It seems like, though, that you would weigh in, in the sense that if it is such, that you're going to be in a posi-

tion that they are FHA-backed, and that could potentially affect the solvency of the insurance fund, it seems like you would take a position.

Ms. GALANTE. Again, Senator, we think it's premature in terms of even beginning to understand how they would operate in an individual localized context at this point.

Senator BOOZMAN. Do you have any comments about this?

Mr. MONTOYA. No, sir. We have not actually looked into the matter. Certainly, it's an area that we're going to monitor and have some concerns over, but I would echo what the Commissioner said. I think these are very localized issues, and how those would be addressed in the local areas is probably the biggest question we would have.

Senator BOOZMAN. Personally, I think it's a huge problem if you're taking mortgages that are current in their payments from individuals. I mean, that, to me, is a huge departure from what's been done in the past. So are you starting to weigh in? Are you looking into this?

Ms. GALANTE. Again, I would just say we think it's premature at this point. Some of the concerns that you have about how one values these mortgages is a big——

Senator BOOZMAN. But you wouldn't do that through guidance. You'd go forward somehow where somebody could weigh in in regard to——

Ms. GALANTE. I'm sorry?

Senator BOOZMAN. I said if that were to happen, we wouldn't just have guidance in how to deal with that. You'd do some sort of rulemaking process or something.

Ms. GALANTE. I think it's hard to say what kind of guidance would be necessary until we understand the details of how these programs might work in an individualized way.

Senator BOOZMAN. Thank you.

Mr. Montoya, you acknowledge that FHA has been slow to respond to many of the recommendations and has only recently implemented some of them. Can you comment on what you see as the primary cause for the delay?

Mr. MONTOYA. Well, going back to the earlier discussion on the HECM program with regard to the taxes and insurance, a lot of those changes or recommendations came out of an audit that happened 3 years ago, and we're only now getting to the point where something is being done. It's our feeling that FHA may be resting too much on the reliance, if you will, on the granting of legislative authority as opposed to beginning the proposed rulemaking process early.

That kind of goes in line with what we've been saying. It's just very slow to address a lot of these forces that in the financial world, if you will, you've got to be able to address pretty quickly. You know, 2 or 3 years down the road, you've not only surpassed it, but you're into another problem. So, again, to echo back to the taxes and insurance issue, that's sort of a more recent example.

Senator BOOZMAN. Can you comment on where you feel the glitches are in not responding quicker to the Inspector General's suggestions?

CHALLENGES TO FHA REFORM

Ms. GALANTE. Let me just say on a more global level, as opposed to just the HECM program, there are several challenges here. The first and foremost, I would say, is to think about the crisis that we've been in for the past number of years. We have had massive amounts of policy changes and rulemaking to do, and we have needed to prioritize at some level our own resources, our analytical resources, our process resources.

All of this goes through our risk management office of evaluation, the Office of Management and Budget (OMB), and so this, you know—we've had a lot on our plates. And when you look at the forward mortgage, which is most of the trillion dollars of portfolio, we certainly have been spending a lot of effort there.

The second point I would make here goes to the resource question of both staffing and also to the FHA transformation project, the information technology. So one of the Inspector General's recommendations to us about how we look at defaulted loans or nonperforming loans—they made some recommendations that also took us a while to implement.

But through use of the FHA transformation project, we were able to put in a very robust claims review process that is meeting all of the Inspector General's recommendations and more. But it took the time and the resources to get the information technology in place in order to perform the reviewing of all loans that went to claim in 2 years, all early payment defaults, plus an algorithm to pick out other high risk loans to review.

So, you know, I think it's very successful that we're doing it. But it took that time to get the systems in place to be able to do it.

Senator BOOZMAN. Thank you.

Thank you, Madam Chair.

Senator MURRAY. Thank you. As everyone is so aware, many families experience a sudden crisis—it could be a health issue, a job loss, or some kind of unforeseeable situation—that leaves them unable to make their mortgage payments, and many of them are today desperately seeking a way to stay in their homes. I've had a lot of constituents come to my office to get help with some kind of loan modification.

We all know appropriate modifications can benefit everyone. It can benefit the homeowner, who can stay in their home; the lender, if they want to avoid some kind of lengthy, costly foreclosure process; and for FHA, loan modifications can help avoid or reduce claims, which is why FHA requires its lenders to provide loss mitigation services to borrowers that fall behind on their payments.

But it seems that lenders may not be adequately fulfilling this requirement. One of the new reforms that FHA is proposing to us would allow HUD to transfer the servicing of loans to a different servicer who could better assist the borrower with some kind of modification.

Ms. Galante, what problems have you seen or can you describe for us in FHA's loss mitigation programs that led you to request that new authority?

LOSS MITIGATION

Ms. GALANTE. Yes, thank you for the question. One of the things we see is that while you may be able to see any individual servicer looking at their overall record, they are—I don't want to say checking the box—but they are meeting the individual steps. But when you look at certain servicers and you see that their particular portfolio has a much smaller rate of successful loan modifications, you say to yourself, "There's something deeper going on in that servicer's shop that somehow our reviews just aren't able to pick up."

So we really want to be able, particularly for those servicers that we see that are not having good outcomes or not having outcomes as good as some of the other servicers—we want to be able, if we can't get them there through other means, to ultimately say, "Look, we've got to take this part of your portfolio and require it to be transferred or require you to subservice and really, you know, just require that you show that you can perform at a different level or have someone else perform for you."

Senator MURRAY. Mr. Montoya, do you think this would improve loss mitigation efforts, this proposal?

Mr. MONTOYA. Well, I think, on its face, we would certainly be supportive of that. Anything that would keep any more losses from the fund occurring would be certainly beneficial.

It's not something we've audited, although we are contemplating doing that later this year because, like anything, there will be risks, I'm sure, and we'll want to find out what that might be to work with the Commissioner early on in addressing them. But I would certainly support anything that would keep any more losses from occurring as beneficial, not only for the fund, but for the communities that they serve and the individuals that are being impacted by these issues.

Senator MURRAY. Mr. Montoya, the work you're doing in partnership with HUD, Department of Justice, and some State attorneys is helping HUD recover money from claims that are paid on mortgages that weren't properly underwritten. In your testimony, you highlighted some of the egregious errors that you uncovered in your review of loans from 2007 to 2009.

I understand that, to date, your office has helped recover hundreds of millions of dollars from these settlements in addition to the funding FHA received from the servicing settlement. Can you explain the investigations you and your partners are undertaking and what exactly you're finding?

OFFICE OF INSPECTOR GENERAL INVESTIGATIONS

Mr. MONTOYA. Sure. Yes, ma'am, absolutely. Thank you for the question. I think all total, to date, my office has recovered over $1 billion. It would probably pay for ourselves a number of times over. But the types of reviews that we're doing are not minor technical reviews. We are looking at wholesale disregard for the FHA insurance program.

We're looking at material type violations that we call incurable, things you can't fix, things like borrowers who never had the income in the first place to afford the home they're buying; no debt

to income ratio analysis that would tell us what other bills they have to pay that would impact being able to make the mortgage; and, quite frankly, something as basic as whether they have the funds to come to closing to close on the loan. So these are the types of things that we're seeing and that seem to be rampant in some lenders.

So, again, what I'd want to stress—because we've heard from a lot of stakeholders, mortgage bankers and others, that we're sort of nit-picking, that we're looking at technical violations, and that couldn't be further from the truth. We've got a number of other lenders we're currently looking at, and we've got more in the pipeline. Quite frankly, I'd have to say we have more than we can deal with, and we've actually had to turn some United States attorneys' offices away that would like to pursue some of these, because much like the Commissioner, we have limited resources, and there's only so much I can do. So we're trying to pick the worst of the worst, if you will.

But, again, just to reiterate, we're talking about wholesale disregard of the program, something as fundamental as whether they can afford the home in the first place, and whether they have the resources to afford it.

Senator MURRAY. You've also recommended that HUD take some steps to avoid paying unnecessary claims, including delaying payments to lenders and reviewing early default loans. What are the specific actions that you would like HUD to take to address some of those recommendations?

Mr. MONTOYA. Well, to reiterate something the Commissioner said, we certainly recognize that staffing is always an issue, and limited resources. But some of the things that we've been recommending are reviews of what we call high risk defaults. These are defaults that have defaulted in the first 24 months of the loan. Those are always red flags for us of how we got there in the first place that early.

You know, reviewing these while they're in the foreclosure process before they become claims, so that—because the foreclosure process can take months and months, that's a very good time to sort of look at these things to see if there was fraud or some sort of mismanagement, if you will, of how they underwrite these loans in the first place, so that HUD could avoid paying these loans if at all possible.

These are the kinds of things that take staff resources, but they're also the kinds of things that the private mortgage insurance companies do. So in a perfect world, we'd like to see more of that happen. Recognizing, too, that HUD has an obligation to pay on these loans within a very short amount of time—you know, the Prompt Payment Act requires them to pay these claims within 30 days. That is insufficient time for them to do really any kind of review of the loan to see if there was any fraud or mismanagement in the underwriting of the loan.

One of the recommendations that we have shared with the Commissioner and would like to talk to Congress and work with this subcommittee on is certifications, an idea concerning certifications by these lenders, where they're certifying that the loan that they're providing to FHA for a claim has been reviewed by them and it

meets all the qualifications of a properly underwritten loan. It puts the onus back on the lender, if you will, and kind of keeps the exposure to FHA down.

While there's a lot of discussion yet to be had on the issue, these are the kinds of things that we are recommending.

Senator MURRAY. Commissioner Galante, do you want to comment on whether that's doable and what you think of it?

Ms. GALANTE. Sure. I would say two things. First of all, we really appreciate the partnerships we have with the Inspector General on improving our quality assurance, our loan review process. I think their recommendations on looking at early payments defaults, for example, and looking at loans on an ongoing basis, we are now doing in a robust way with the help of our technology, which is from your help. Thank you.

We think we're on the right path now going forward for some of those processes. We recently have talked about additional legislative items we might need or administrative actions that we could take, including looking at how good the certifications we have are. We're certainly willing to work with the IG on looking at that.

Senator MURRAY. My time has expired, so I'll turn to Senator Collins.

Senator COLLINS. Thank you.

Commissioner, you have mentioned that the FHA's market share is decreasing and beginning to return to more traditional levels. Is a reduction in market share a goal of this administration?

FHA'S MARKET SHARE

Ms. GALANTE. It is a goal of this administration that FHA return to a more normalized, traditional role in the marketplace. How one measures market share is an interesting challenge, in that one of the things that we've seen through this whole crisis is that the whole market has shrunk. So even though FHA's absolute dollar amount could stay the same, you need to have private capital come back in so that you're growing the whole market in order for our market share to begin to drop.

We are beginning to see that, and I think there's a couple of reasons for that. One is that the premium increases that we've made and some of our other policy changes are encouraging private capital to come back. But I also think private capital is starting to come back because they're seeing the—you know, we've played a countercyclical role, the market is getting better, and we're seeing that private capital is now willing to put more financing available in the marketplace.

Senator COLLINS. Let me talk about the premium increases that you mentioned and what strikes me as a possible unintended consequence of some of the policy changes. FHA, as you mentioned, has announced several premium increases in an effort to improve the financial health of the fund.

I was surprised to read that one of the changes that was also included was to not allow borrowers to cancel their annual mortgage insurance premium when they reach the level where they have sufficient equity in their homes. This strikes me as not fair, but it also strikes me as leading to a perverse outcome where that borrower who has clearly been paying on time and has reached a certain

level of equity is going to refinance out of FHA and leave you with a pool of more risky borrowers.

So why would you want to implement that change?

Ms. GALANTE. Thank you, Senator Collins. This may be a bit counterintuitive, but I think this is a hugely important policy that FHA is doing, and let me explain why. First of all, the policy of allowing cancellation of the premium did not come into effect at FHA until about 2000, 2001. So for most of FHA's history, the policy we're talking about reversing now was not in place.

There's a bit of history that I don't really know, but I've heard, about why FHA back in 2001 did this. It was because the private mortgage insurers were going in this direction. But the challenge here is—and this is why it's important to have a good risk management office—the risk for the private mortgage insurers is entirely different than the risk for FHA. They're only insuring the top part of the loan. FHA is insuring the entire part of the loan.

Even if you buy on an amortizing basis, have more equity, theoretically, in your home, we still have risk that if home prices go down, as they did during this crisis, we're still on the hook for the risk for that loan. In fact, one of the things we saw is that we were continuing to see claims, have defaulted loans on loans after they had stopped paying on their MIP, because it was an automatic cancellation.

So we lost during the crisis by having that old policy in place. We lost, our risk manager believes, probably $10 billion of revenue that we would have otherwise had, and as prices declined, we would have had more revenue to deal with the losses. So we think this is an important reversal of policy for the future. As long as home prices are going up, up, up, maybe you'll have some people refinance out of these loans. But in the long term, ensuring that your premium matches the risk that you're taking on was the most important thing here.

Senator COLLINS. Have you seen homeowners refinancing out of FHA-insured loans in order to avoid that mortgage premium insurance payment?

MORTGAGE INSURANCE PREMIUMS

Ms. GALANTE. This policy just went into effect, so we haven't——

Senator COLLINS. It's too soon.

Ms. GALANTE. It's too soon to tell. But I would also just say that, primarily, what's going to drive people to refinance is our interest rates.

Senator COLLINS. Right.

Ms. GALANTE. So that's really going to be what drives people to decide to refinance or not.

Senator COLLINS. Let me talk to you about the financial health of the FHA single family mortgage mutual fund. We've all mentioned the fact that the budget request shows that you anticipate drawing on your authority with the Treasury during this year to hold in reserve against expected future losses. Obviously, $943 million is a lot of money and is of great concern to us, or to me, because it would be the first time that you have taken this step. We thought it was going to happen last year, and then it didn't because of the settlement.

Have conditions changed since that budget request, or do you still anticipate drawing that amount of money from the Treasury? What's your current prediction?

Ms. GALANTE. Two things I do want to say. While we projected that we might draw last year and we didn't, and we certainly did get a number of settlements, we also made a number of policy changes that impacted, and we had volume that went up. So we would have ended up not drawing—even without the settlement dollars, we ended up with $3 billion positive as opposed to the draw of—I think it was $688 million that we thought we might take.

And I say that because this year, the main thing that will drive whether we draw or not draw is whether our—this year, we have done all the premium increases and the policy changes before this budget came out, so those are kind of baked in. Those expectations of revenue are already baked into the budget. So the one thing that will change is whether we have a significant increase in volume. Then we would be less likely to draw or to draw that amount of money.

And the other thing that I just would want to get out on the table here is if we, through the policy changes that we've been making, see significant improvements as a result of those policy changes in our recoveries, you know, on defaulted loans, on our real estate owned, that could, in consultation with OMB, change the trajectory.

Senator COLLINS. What's your current estimate? You said that your premium increases are already baked into the budget. So, presumably, that's baked into the $943 million.

Ms. GALANTE. Yes. The premium increases are already baked in. So, again, it will depend primarily on volume and whether there is a significant credit given to the recovery efforts that we've been taking on in terms of getting better on our recovery of our loans.

Senator COLLINS. So do you have an estimate for us, a new estimate?

Ms. GALANTE. We do not.

Senator COLLINS. Thank you, Madam Chair.

Senator MURRAY. Senator Boozman?

Senator BOOZMAN. Thank you, Madam Chair.

Mr. Montoya, you mentioned that we have situations where you have just wholesale disregard for the rules, the high risk defaults, where you just know there's something going on based on that. Is there adequate legislation in place to deal with that right now? Do we have the safeguards to deal with the individuals who everybody in the room would agree are blatantly playing the system to their advantage?

FRAUDULENT LENDER SAFEGUARDS

Mr. MONTOYA. Well, I appreciate the question, sir. Thank you. I think in one regard, the answer would be no. I think we could strengthen some of that. Right now, the way the laws are set up, a lender, i.e., being the company, that's found to be in violation of FHA's underwriting standards and that we're, in essence, going after, can simply shut their doors today. The very individuals who were running that lending company could go start up a new lending company tomorrow and be back in the business.

So, unfortunately, we're not set up so that we can go after an individual. Shy of proving that they, specifically, they, themselves, have committed a fraud, which is very difficult to do, there's no way to sort of tack onto them the effects of the fact that they were running a poor company that poorly underwrote loans. So, in other words, there's no way for us to suspend them, specifically, individually, from being involved in the FHA program.

So that's an area that we will be recommending some legislative language on. That would probably be the biggest thing. And I think until you can tag individual responsibility onto individuals for this kind of stuff, I'm not sure that we'll do much to change the culture of somebody who wants to defraud us.

There's risk in any insurance program, as you well know, and we're never going to be 100 percent risk free. To the extent we can mitigate that, that would, to me, be one big mitigating factor to consider.

Senator BOOZMAN. Very good.

Ms. Galante, do you agree, or can you add to that?

Ms. GALANTE. Yes. I would just say I think this is an important issue and a very tricky one, and we share the concern with the Inspector General. What you're struggling with here is basic corporate law, in terms of if you're a corporate officer and you're doing things in the name of the corporate officer. I think there are some ways that we could explore to address this particular issue, but it is tricky.

The other thing I would say is there are other items, in terms of help with enforcement, that we certainly legislatively would like and some of which we have asked for and were passed twice by the House. And we would very much like to work with the Senate to get those particular authorities to be able to terminate lenders based on their national work. Right now, if they operate in different geographies, we have to go after them in each of the geographies in which they're operating, which is obviously a challenge.

And we don't have what's called indemnification authority for every class of lenders that we have. We have it for most of them, but not all of them. Those are two additional legislative asks that we would have in terms of enforcement authority.

Senator BOOZMAN. Very good.

Mr. Montoya, I guess the only other thing I'd ask is what are the top couple—I read your testimony. What are the top couple of things that you feel that we as a Congress—you know, we're talking about this, and you said that you were prepared to perhaps come forward with some suggested legislation that we could look at and be more helpful. What other things are out there? What are your top couple of things that you'd like to see us maybe step forward on?

This is a huge issue, and it affects those in the housing market, in the sense of trying to get in a home. All this stuff does is increase costs, and then also the cost to the taxpayers. Do you have any other things that you could dwell on for a second?

Mr. MONTOYA. Yes, sir. Thank you for the question. Certainly, FHA faces a difficult challenge in striking that balance between protecting the fund, making the program attractive to prospective homeowners, lenders, that sort of thing.

I think one of the things we're concerned with is that FHA is sort of too concerned, really, with regards to market share. While I understand they're coming down from that market share, I think, historically, we've seen too much of a concern on market share. By that, you end up taking risks, you know, for the simple reason of do you want to keep these lenders in the program. So that's one concern.

INFORMATION TECHNOLOGY INFRASTRUCTURE

I think sort of the biggest concern for really what is a financial institution is their aging IT infrastructure and their ability to manage this high finance world, if you will, on systems that are 15 and 30 years old. I think in the budget request, if I remember correctly, that FHA submitted, they're asking for over $100 million in one budget cycle just for maintenance of these aging systems, and they're just going to get older every year.

My major concern from an IT perspective when we come and do the financial information security type reviews is could we end up having a major, major issue with the IT portion of it, i.e., losing data, is it vulnerable to manipulation, these sorts of things. So that would probably be my biggest concern, and as appropriations go, that takes money. I recognize that.

But when you're spending $100-plus million a year on just maintenance of old systems, at some point you've got to pull the bandage and say, "Okay, we've got to upgrade these things."

So those are probably my two biggest issues, you know, too much emphasis on the lenders in the program and trying to keep that market share, as opposed to just letting FHA do the cyclical rule that it's always done; and the IT infrastructure.

STAFFING CONCERNS

I think the other thing I would add is the staffing concerns that FHA and, quite frankly, their sister counterpart in the Department, Government National Mortgage Association (GNMA), has, and that's staffing. I think some of the critical roles that both of these organizations have—I don't believe the pay structure allows them to recruit and retain the best that we could probably get because we're competing with the private sector market.

And much like FHFA, as you mentioned earlier, the Securities and Exchange Commission, these organizations have additional budgetary salary authority to allow for that increased salary for key positions. I would certainly support something like that on behalf of FHA and GNMA to get the right qualifications you need to deal with some of these issues. So probably those three things.

Senator BOOZMAN. Thank you.

Madam Chair, with your permission, could I ask if she agrees?

Senator MURRAY. Absolutely.

Senator BOOZMAN. I think he's trying to help you. Do you agree with the aging infrastructure and the things like that that Congress perhaps needs to help out with to help you do a better job?

Ms. GALANTE. Absolutely, I do, and it's very difficult. You can't retire the old systems until you build the new systems. You still have to continue to function in an ongoing environment—so the aging infrastructure. I agree with the staffing issue, and I would

disagree a little bit on market share, but I think I would say it a little differently. We are concerned about the balance between access to credit for folks and the variety of controls we need to put on enforcement. So I think we're in the same basic place.

Senator BOOZMAN. Thank you, Madam Chair.

Senator MURRAY. For the record, would you give us what your priorities are on the IT? We have invested quite a bit, and I'm worried about that as well.

[The information follows:]

For the last 80 years, the Federal Housing Administration (FHA) has played a critical role in support of the housing market. FHA has provided sustainable affordable housing for millions of Americans while also playing a critical countercyclical role during times of economic stress.

FHA's capacity to deliver on this mission is increasingly at risk due to operational constraints and technology challenges. FHA's budgetary constraints, its uncompetitive compensation structure, and outdated technology put its core mission at significant risk and expose taxpayers to potential financial losses that can be avoided.

The outdated technology challenges start with the two, core FHA information technology (IT) systems known as CHUMS and FHAC. These systems, which manage hundreds of billions of dollars of transactions, are between 30–40 years old. These core systems are surrounded by more than 20 other fragmented systems, which handle ancillary, but critical functions.

While the technology already at FHA's disposal is challenged, there are also technology tools that FHA does not have, but desperately needs. These include effectively risk-monitoring tools, portfolio evaluation systems, and risk modeling technologies. These are all standard systems in the mortgage markets, which FHA lacks.

These technology issues lead to a number of significant management challenges, including:

—Lack of access to timely and useful data to inform risk management and mitigation decisions;
—Reliance on volumes of paper and manual processes that lead to significant errors and suboptimal allocation of resources;
—Persistent data integrity issue—different systems say different things; and
—Challenging operational constraints which make it difficult for FHA to implement new quality assurance and risk mitigation actions.

FHA generates more than $10 billion in receipts and pays out billions in claims each year.

And while FHA Transformation—an initiative launched to address these challenges—has clear and significant payback (e.g., estimated at more than a billion dollars over the next several years), lack of funding has put the program at risk.

FHA TRANSFORMATION

FHA Transformation was launched several years ago to remedy the exhaustive list of IT challenges. Specifically, the initiative aims to address three main management challenges through better technology infrastructure:

—Detect and prevent fraud, waste, and abuse:
  —Automate the aggregation of lender, borrower, and asset information of inbound data;
  —Automate the aggregation of lender and appraiser past behavior and violation history; and
  —Synthesize high-risk profile information and past, actual fraud data.
—Prudently manage credit risk at both the portfolio and loan level:
  —Develop comprehensive portfolio, borrower, and collateral risk analytics;
  —Implement a portfolio evaluation tool to enable default, prepayment, home price, and cash flow modeling and loan-to-value (LTV) analysis;
  —Support the Office of Risk Management by enhancing forecasting capabilities and analytical;
  —Run situation-specific ad hoc reports and scenarios on the Single Family Housing (SFH) portfolio; and
  —Provide monthly refreshed credit data at the loan level for borrowers.
—Respond rapidly to changing market conditions:
  —Provide a common, modern platform that supports rapid deployment and continued modification of current and new FHA business systems and processes;

—Deliver a single source of authoritative data from which to perform risk analytics and other operational reporting;
—Following migration of functionality, decommission legacy systems within SFH, Multi-Family Housing (MFH), and Healthcare; and
—Simplify process of making changes to underlying system business rules.

At the time this initiative was launched, the estimated cost was set at approximately $115 million. Given FHA generates more than $10 billion in receipts and billions in losses, this investment has clear and immediate payback.

PROGRESS ON FHA TRANSFORMATION

Significant progress has been made on FHA Transformation to date. This includes:
—Investment in basic infrastructure that will replace the core systems;
—Launch of front-end system that accepts lender certification;
—Portfolio analytics that has identified billions of dollars of improvement potential in how FHA disposes of assets; and
—Piloting and testing electronic application processing tools.

About half the investment FHA needs has been made to date to achieve this progress.

APPENDIX

IT challenges in the Single Family portfolio:
—Unclear picture of full credit risk on a loan and inconsistent referral of higher-risk loans for manual underwriting;
—TOTAL system allows lenders an unlimited number of pre-qualification submissions with only a limited audit trail;
—Reliance on multiple automated underwriting systems not owned by FHA;
—Heavy reliance on manual processing and paper case binders sent in by lenders;
—Manual application verification processes;
—Inability to automatically validate appraised value prior to loan closing and endorsement and unable to receive appraisal information through direct interface with lenders;
—Lack the capability to accept eSignatures;
—Post endorsement and appraisal reviews based on outdated algorithms and thus unable to effectively target most risky loans;
—Lack ability to track lender activity and interactions with lenders over time, increasing risk of fraud; and
—Data integrity and data reporting issues leading to manual data entry, processing delays and limited accuracy.

IT challenges in the Multifamily and Healthcare portfolios:
—Inability to proactively identify and mitigate risk due to lack of capability to share and analyze data (no central data, paper based application processing);
—Processes are entirely manual, relying mostly on MS Word and Excel, for credit analysis and write-ups;
—Difficult, and in many cases, impossible to implement new programs in existing systems; and
—Limited management reporting.

Senator MURRAY. But I just had one final question, and that is that you recently announced a significant reorganization of the Office of Multifamily Housing. It's going to affect about 900 HUD employees over the next several years. The administration has rightfully said this move will reduce costs, create efficiencies, and improve program delivery.

But those changes are going to mean fewer staff available to oversee and manage HUD's programs, and it means that HUD staff will not be located in many areas of our country, a concern that some multifamily housing providers in my State have raised with me personally. Can you just tell us how you can ensure that oversight will not be compromised under this new structure and that customers will continue to see the same level of service, particularly in places where HUD is no longer going to have an office?

OFFICE OF MULTIFAMILY HOUSING

Ms. GALANTE. Yes, thank you. Clearly, it is challenging to operate on a national platform with the demand on the multifamily office. I just want to say that in terms of long term, this is critical to get our workload balanced across the country.

So just to give you a quick example of why I believe that we will be able, long term, to operate in a more consolidated fashion across the country is that we have severe imbalances in all these 50 offices in the number of assets. We have some offices where project managers are responsible for over 200 assets, and in other parts of the country, they're responsible for 30 assets per project manager. So what you see is just a vast imbalance of workload.

We're trying in a whole variety of ways to balance that out. But one long-term way of doing it is consolidating the personnel into larger geographic areas so that they can share that work more evenly and stay within our very severe budget constraints. At the same time, given how we are in an electronic world, we believe that through technology and through other means, including travel, we will ensure that customers are served in all locations.

Senator MURRAY. And they know the areas that——

Ms. GALANTE. In local areas. And we'll have specialized teams within these larger consolidated teams with local knowledge and connections to the local community.

Senator MURRAY. I appreciate that very much.

ADDITIONAL COMMITTEE QUESTIONS

I do want to remind my colleagues that we're going to leave the hearing record open for 1 week for additional questions.

I thank both of you for appearing before this subcommittee today.

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

QUESTIONS SUBMITTED TO HON. CAROL GALANTE

QUESTIONS SUBMITTED BY SENATOR BARBARA A. MIKULSKI

CONSOLIDATION OF THE OFFICE OF MULTIFAMILY HOUSING

Question. Federal agencies must always be frugal. And they must use taxpayer dollars responsibly. But in the current budget environment, it's even more important for agencies to think of reforms to make sure that every dollar of the taxpayers' money is being used as wisely as possible. This consolidation will have an impact on the employees at field offices across the country, and the Americans who rely on the work that they do. How did you determine that consolidating down to five hubs and five satellite offices was the best way to achieve your efficiency goals?

Answer. Please see the end of this response for several exhibits that illustrate this explanation of the decision to consolidate to five hubs and five satellite offices. The current field structure has 17 hubs and employees in over 50 field offices. This structure leads to five key areas of concern:

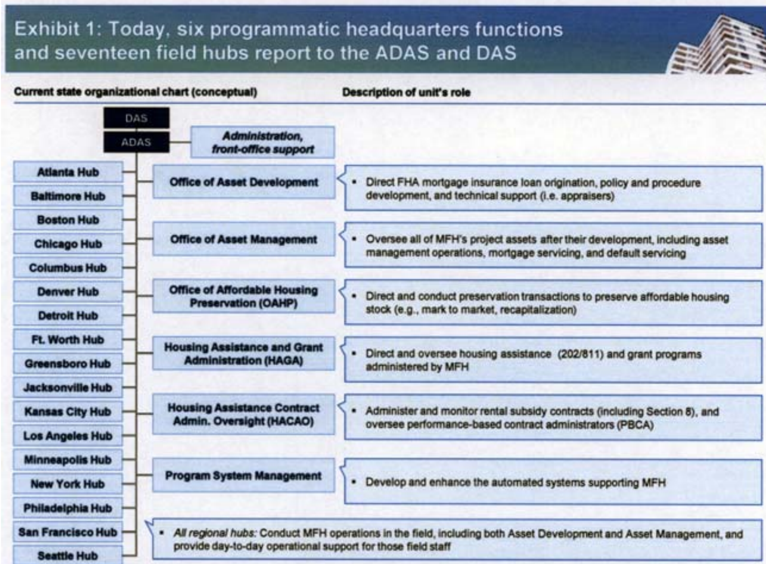
—Unmanageable spans of control at the top of the organization. Currently, the Multifamily deputy assistant secretary (DAS) has nearly 25 direct reports, with 17 hubs and 6 headquarter (HQ) functions (see Exhibit 1);

—Inconsistent operations across 50+ locations, leading to inconsistent customer service across geographies (particularly for our largest customers), and inhibiting effective risk management (see Exhibit 2);

—Misalignment between Multifamily's structure and the established Federal regions, leading to inconsistent coordination between Multifamily and the rest of the Department of Housing and Urban Development (HUD);
—Over 4x workload imbalance across hubs in Production, and 3x in Asset Management (worse within individual offices), leading to long queues in some markets and underused staff in others (see Exhibit 3); and
—Low spans of control in many field offices (e.g., one manager over two staff), creating unnecessary layers and stifling employee engagement.

The proposed structure will directly address each of these failures in the following ways:

—The new five-hub model significantly reduces the number of direct reports to headquarters, making management of the field organization simpler and more streamlined (see Exhibit 4):
—Consolidating to 10 locations enables greater consistency in Multifamily's operations, enabling us to deliver more consistent service to our customers while more consistently managing the risk of the entire Multifamily portfolio;
—The new five-hub model is more in line with the established Federal regions, which will allow for better coordination between Multifamily and the rest of HUD (see Exhibit 5);
—Workload across each of the five regions will be more evenly distributed; each region will handle a similar volume in both Production and Asset Management (see Exhibit 6); and
—The reorganization will produce greater spans of control—in line with HUD policies and Federal standards—ensuring all locations operate at scale, allowing us to make the most of scarce financial resources.



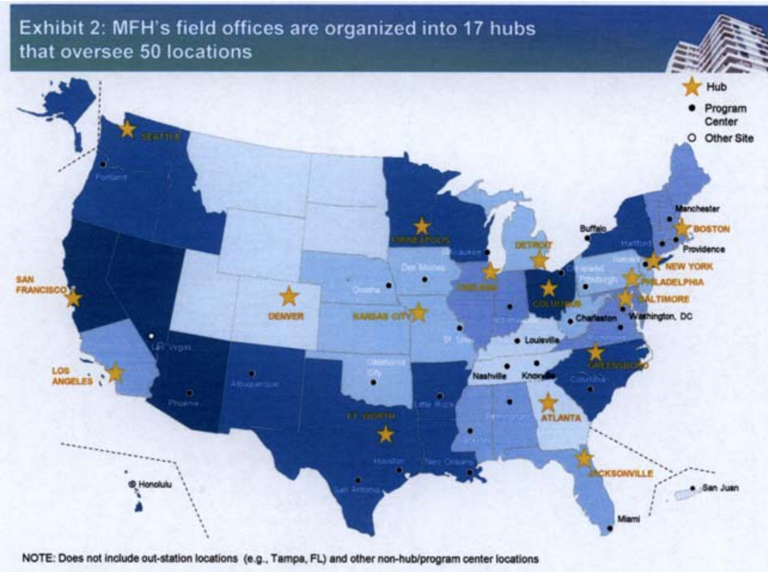


Exhibit 2: MFH's field offices are organized into 17 hubs that oversee 50 locations
Hub
Program Center
Other Site
SEATTLE
SAN FRANCISCO
LOS ANGELES
DENVER
KANSAS CITY
FT. WORTH
DETROIT
COLUMBUS
Buffalo
Manchester
BOSTON
Providence
NEW YORK
PHILADELPHIA
BALTIMORE
Washington, DC
Charleston
Louisville
Nashville
Knoxville
GREENSBORO
ATLANTA
JACKSONVILLE
Miami
San Juan
Honolulu
NOTE: Does not include out-station locations (e.g., Tampa, FL) and other non-hub/program center locations

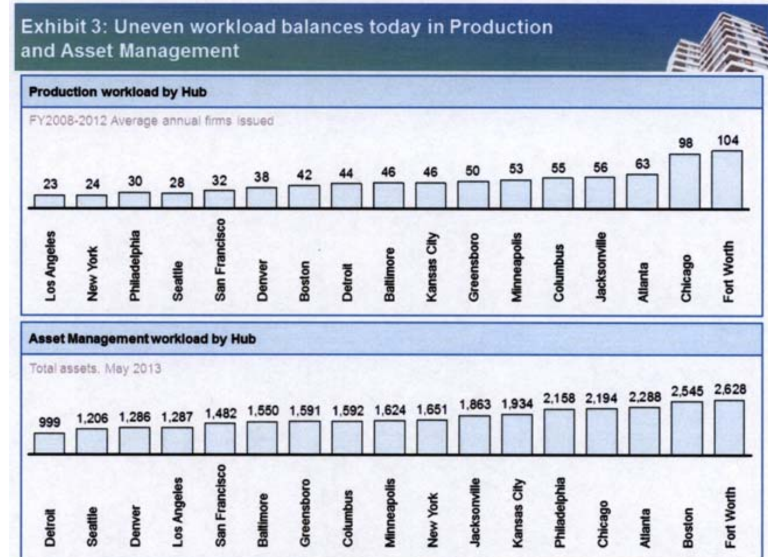


Exhibit 3: Uneven workload balances today in Production and Asset Management
Production workload by Hub
FY2008-2012 Average annual firms issued
23 Los Angeles
24 New York
30 Philadelphia
28 Seattle
32 San Francisco
38 Denver
42 Boston
44 Detroit
46 Baltimore
46 Kansas City
50 Greensboro
53 Minneapolis
55 Columbus
56 Jacksonville
63 Atlanta
98 Chicago
104 Fort Worth
Asset Management workload by Hub
Total assets, May 2013
999 Detroit
1,206 Seattle
1,286 Denver
1,287 Los Angeles
1,482 San Francisco
1,550 Baltimore
1,591 Greensboro
1,592 Columbus
1,624 Minneapolis
1,651 New York
1,863 Jacksonville
1,934 Kansas City
2,158 Philadelphia
2,194 Chicago
2,288 Atlanta
2,545 Boston
2,628 Fort Worth

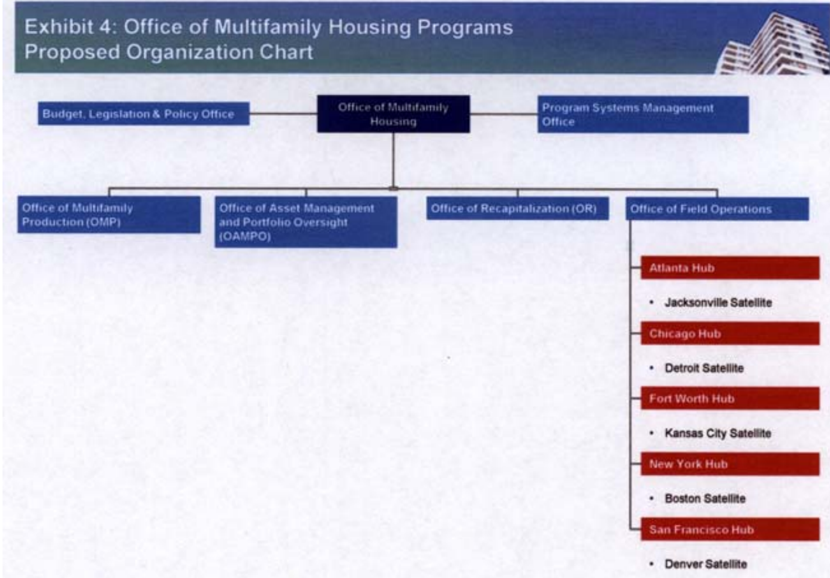


Exhibit 4: Office of Multifamily Housing Programs
Proposed Organization Chart
Budget, Legislation & Policy Office
Office of Multifamily Housing
Program Systems Management Office
Office of Multifamily Production (OMP)
Office of Asset Management and Portfolio Oversight (OAMPO)
Office of Recapitalization (OR)
Office of Field Operations
Atlanta Hub
• Jacksonville Satellite
Chicago Hub
• Detroit Satellite
Fort Worth Hub
• Kansas City Satellite
New York Hub
• Boston Satellite
San Francisco Hub
• Denver Satellite

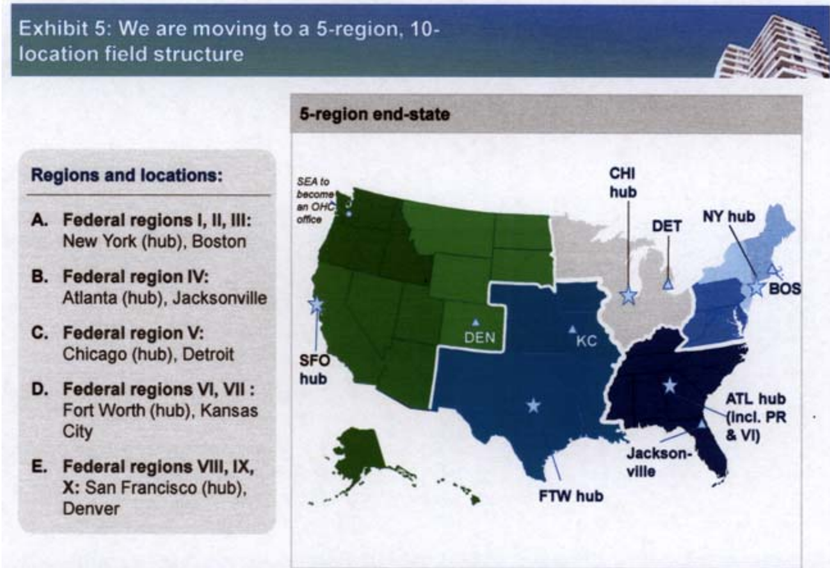
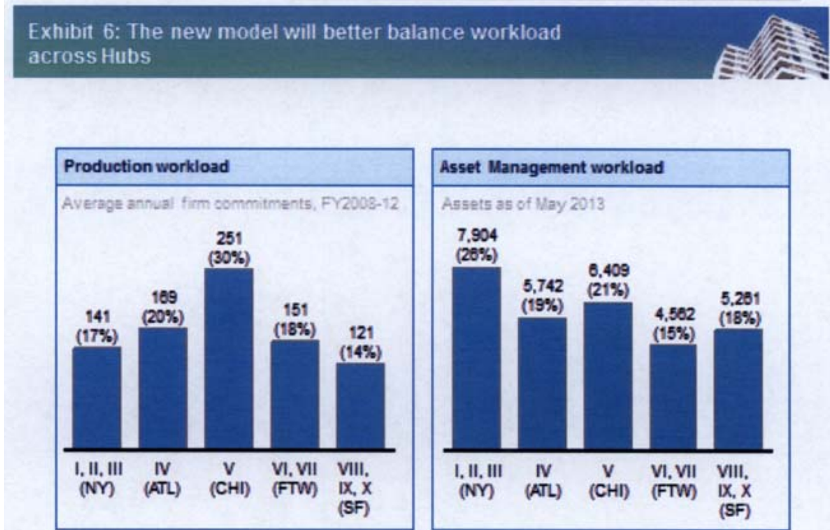
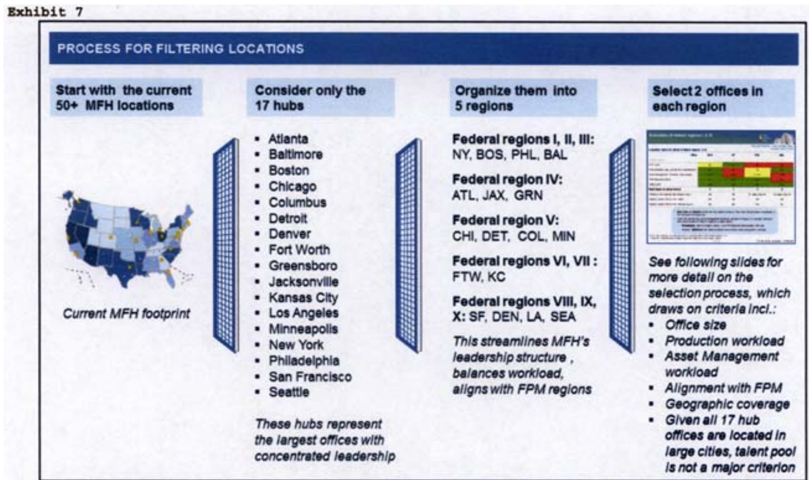


Exhibit 5: We are moving to a 5-region, 10-location field structure
5-region end-state
Regions and locations:
A. Federal regions I, II, III: New York (hub), Boston
B. Federal region IV: Atlanta (hub), Jacksonville
C. Federal region V: Chicago (hub), Detroit
D. Federal regions VI, VII : Fort Worth (hub), Kansas City
E. Federal regions VIII, IX, X: San Francisco (hub), Denver
SEA to become an OHC office
CHI hub
DET
NY hub
BOS
DEN
KC
SFO hub
ATL hub (incl. PR & VI)
Jackson-ville
FTW hub



Question. How was the decision made to close the HUD Maryland Office of Multifamily Housing and all the offices in Region 3?

Answer. Within this response are two exhibits that illustrate this explanation, including a detailed breakdown of the comparison of Boston, New York, Philadelphia, and Baltimore. First, it is worth noting the Multifamily is not closing any HUD field offices; other HUD staff will remain in the Baltimore field office. However, we do understand the concern about consolidating Multifamily's field structure, which means that Multifamily staff will relocate from the Baltimore office. To determine which 10 offices would serve as the future Multifamily hub and satellite offices, we first began by only considering locations that were already hubs (see Exhibit 7).



In order to then streamline the Multifamily leadership structure, balance workload, and align with Field Policy and Management (FPM) regions, we then organized the hub offices into five geographic regions: the first covers Federal regions I, II, and III (the Boston, New York, Philadelphia and Baltimore offices); the second covers Federal region IV (the Atlanta, Jacksonville, and Greensboro offices); the third covers Federal region V (the Chicago, Detroit, Columbus, and Minneapolis of-

fices); the fourth covers Federal regions VI and VII (the Fort Worth and Kansas City offices); and the fifth covers Federal regions VII, IX, and X (the San Francisco, Denver, Los Angeles, and Seattle offices) (see again Exhibit 7).

Finally, we compared offices from within the proposed five regions based on several factors: the full-time equivalent (FTE) count in each; the Production workload (average annual firm commitments); the Asset Management workload (total assets); and whether an FPM Regional Administrator sat in that office (see again Exhibit 7).

In determining which two offices to select from Federal regions I, II, and III, we ranked Boston, New York, Philadelphia, and Baltimore against each other based on these criteria. Based on these criteria, Baltimore and Philadelphia were ranked lower than other offices in the new Multifamily region (see Exhibit 8).

Exhibit 8

High / Medium / Low

Evaluation matrix for offices in federal regions I, II, III

Office:	BOS	NY	PHL	BAL
Federal Region	I	II	III	III
Office size: FTE count	40	57	30	32
Prod workload: Avg. annual firm commitments[1]	42	24	30	46
Asset Management workload: Total assets[2]	2,545	1,651	2,158	1,550
FPM Regional Admin	Yes	Yes	Yes	No
Geographic coverage: Highest ranked office in state	NA	NA	NA	NA
Rank based on above factors	1	1	3	4

NOTE: High, Medium, Low rankings based on comparing offices within federal regions I, II, III
1 FY2008-2012 Average annual firms issued
2 May 2013

Question. What will be the effect on HUD's processing of multifamily loans and the review of projects during consolidation and after it?

Answer. We believe that this transformation will improve the way we do business by enhancing our efficiency, risk management, and consistency—which will in turn improve our ability to deliver on our mission of providing affordable housing.

Prior to the consolidation of field offices, we will roll out workload sharing nationally across Multifamily offices. Once consolidation begins, workload sharing will allow us to take work "offline" from impacted offices and move it to other areas of the country in order to ensure continuity of operations and excellent customer service.

As we complete the implementation of each wave, all Multifamily loans will be reviewed through a formalized "risk-based processing" approach that segments incoming applications based on risk and complexity. Staff will be assigned to applications based on the particular expertise and experience that assessing those loans will require. More experienced underwriters will process riskier, more complex applications. These underwriters will oversee an end-to-end review of each application, continuing to draw in technical experts such as construction analysts and appraisers as needed. While our staff already considers risk and complexity in their work, we believe that formalizing this process will improve the consistency of our risk management and service delivery. This process complements tools introduced in the Breaking Ground initiative like the "Early Warning System," which allowed Production staff to rapidly identify applications that required further review by the submitter before being processed.

In addition to clarifying roles, we will also be identifying opportunities to streamline the underwriting process to ensure that simple applications are not being overprocessed. We believe that this approach to Production will improve risk management by focusing expert attention on the most challenging applications, improve customer service by providing a clearer point of contact and more streamlined processing, and improve the overall efficiency of Multifamily's Production operations. This model has already proven successful in the Rental Assistance Demonstration and Low-Income Housing Tax Credit pilot. Many field offices are already experimenting with variants of this model, and through the Transformation we will formalize it and make it more consistent.

A similar approach will also be adopted in Asset Management, whereby complex and troubled assets will be assigned to Multifamily's most expert staff. This approach is again consistent with the risk-based approach introduced to Asset Management by Sustaining Our Investments. We will continue conducting on-site in-

spections and reviews as required by our policies and procedures. Today, we already manage assets and review applications from around the country, even when we have no nearby field office. We plan to continue this approach in the future.

Question. How will this consolidation affect smaller banks and lenders?

Answer. Like all Multifamily stakeholders, smaller banks and lenders will continue to have the same level of access to dedicated Multifamily staff that they have today. Due to shorter processing times and improved consistency across sites, banks and lenders should expect improved customer service from Multifamily.

Question. I understand that you have promised the employees transparency and that you will keep them informed of changes; what steps have you taken, and what will you do as the process continues, to make sure that employees are kept up-to-date on the consolidation?

Answer. In order to maintain an open dialogue between leadership and staff, the leadership at HUD and within Multifamily has conducted an extensive series of in-person, on the phone, and Web casts with staff. So far, this has included over two dozen different interactions, including 10 visits to field offices across the country. Multifamily leadership plans to continue these conversations into the foreseeable future. After the initial announcement, FHA Commissioner Carol Galante and Deputy Assistant Secretary Marie Head conducted a series of conference calls with each hub, during which they answered questions and collected feedback. Secretary Donovan, Deputy Secretary Jones, Commissioner Galante, and Deputy Assistant Secretary Head are all conducting site visits to field offices to meet with and take questions from Multifamily staff in person. During several biweekly conversations with the Deputy Secretary, which are broadcast every other Friday, the Deputy Secretary has provided answers to frequently asked questions and has hosted subject matter experts to describe employee options for relocating, buyouts and early retirement.

Multifamily is committed to providing "on demand" resources to staff. We have created dedicated Web sites on HUD.gov and on the internal HUD@work site. We also continue to track incoming questions from individual employees, and regularly update the Questions and Answers found online[1]. Finally, we have set up a call center in the Office of Housing that directs employees to the appropriate subject matter experts.

We are preparing local supervisors to hold conversations with individual staff members regarding their relocation destination, so that employees know, to the maximum extent possible, where we are proposing to relocate them. Once union negotiations are complete, we will launch a new series of communications with employees in order to inform them of the outcomes of negotiations and to provide individuals with the location of their directed reassignments and the timing of buyout offers.

We expect that this regular cadence of communications will continue throughout the multi-year implementation of the transformation, as we remain committed to informing staff of the latest developments.

CONCLUSION OF HEARINGS

Senator MURRAY. This hearing is recessed until Thursday, June 13, at 10 a.m. We'll have a hearing on our need to invest in our Nation's transportation infrastructure.

So thank you again to both of you.

[Whereupon, at 3:55 p.m., Tuesday, June 4, the hearings were concluded, and the subcommittee was recessed, to reconvene at 10 a.m., Thursday, June 13.]

[1] http://portal.hud.gov/hudportal/documents/huddoc?id=052813TrnsfrmMF__FAQs.pdf.