U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410

Written Testimony of Edward L. Golding
Principal Deputy Assistant Secretary for the Office of Housing
U.S. Department of Housing and Urban Development (HUD)

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I. Introduction

Thank you, Chairman Luetkemeyer and Ranking Member Cleaver, for the opportunity to testify about the ongoing work of the Federal Housing Administration (FHA).

Since 1934, the FHA has played a critical role in the U.S. housing market. Born out of the Great Depression, the FHA has a dual mission: 1) to ensure access to affordable credit for housing to underserved borrowers and markets; and 2) to act as a countercyclical force that sustains the housing market in difficult or uncertain times, reducing negative economic impacts on the economy. In recent years, FHA has been called upon to play both roles – in response to the crisis and as the economy and housing market continue to recover.

By making sure borrowers, particularly first-time homebuyers, have access to affordable credit to purchase homes, FHA supports and expands the middle class, helps families put down roots in communities, and gives them the opportunity to accumulate wealth and build long-term financial stability. With the tendency of the private marketplace to restrict credit, especially in the face of uncertainty or risk, FHA's presence helps to create a balance that allows for stability in the housing market and extends opportunity for homeownership to a much broader segment of the population.

FHA's Mutual Mortgage Insurance Fund (MMIF or "the Fund") bore the strain of the Great Recession, falling below its required capital reserve and eventually taking a mandatory appropriation in 2013. However, FHA's focus on risk management, increasing revenue, and program improvements resulted in the ratio returning to 2 percent in 2015. This achievement was the result of FHA's prudent policy changes, and an ability to work with Congress to pass stabilizing legislation and quickly implement program changes over the course of several years.

This significant increase in value has coincided with the slow, but steady improvement in the state of the U.S. housing market. U.S. Census Bureau data show that recent building permits are up more than 14 percent over the previous year and total housing starts for 2015 were nearly 11 percent higher than

2014.[1] National unemployment has fallen to 5 percent, while consumer confidence and home prices continue to rise.[2]

Today, FHA's position is strong and continues to improve. FHA remains committed to its mission to address underserved borrowers and mortgage markets and this testimony discusses FHA's most recent Annual Report and offers a closer examination of the impact of FHA's Home Equity Conversion Mortgage (HECM) program.

II. 2015 Annual Report – Status of the Fund

Volume and Market Share

FHA endorsements accounted for 19 percent of the total purchase mortgage market and 14 percent of the total refinance mortgage market through FY 2015. FHA's market share is a reflection of efforts to serve the agency's mission of promoting responsible, affordable lending to borrowers at all income levels and to ensure the availability of mortgage credit during national and regional downturns. Its general downward trajectory reflects the continued recovery in the market and FHA's ongoing role[3]. In Fiscal Year (FY) 2015, FHA endorsed 1,116,232 mortgages through the Single Family program. By dollar volume, 66 percent of FHA mortgages were for purchase and 34 percent were for home refinances. These mortgages went to borrowers with an average credit score of 680 and represent an average loan size of $190,928 for all mortgages, and an average loan size of $186,176 for purchase mortgages.

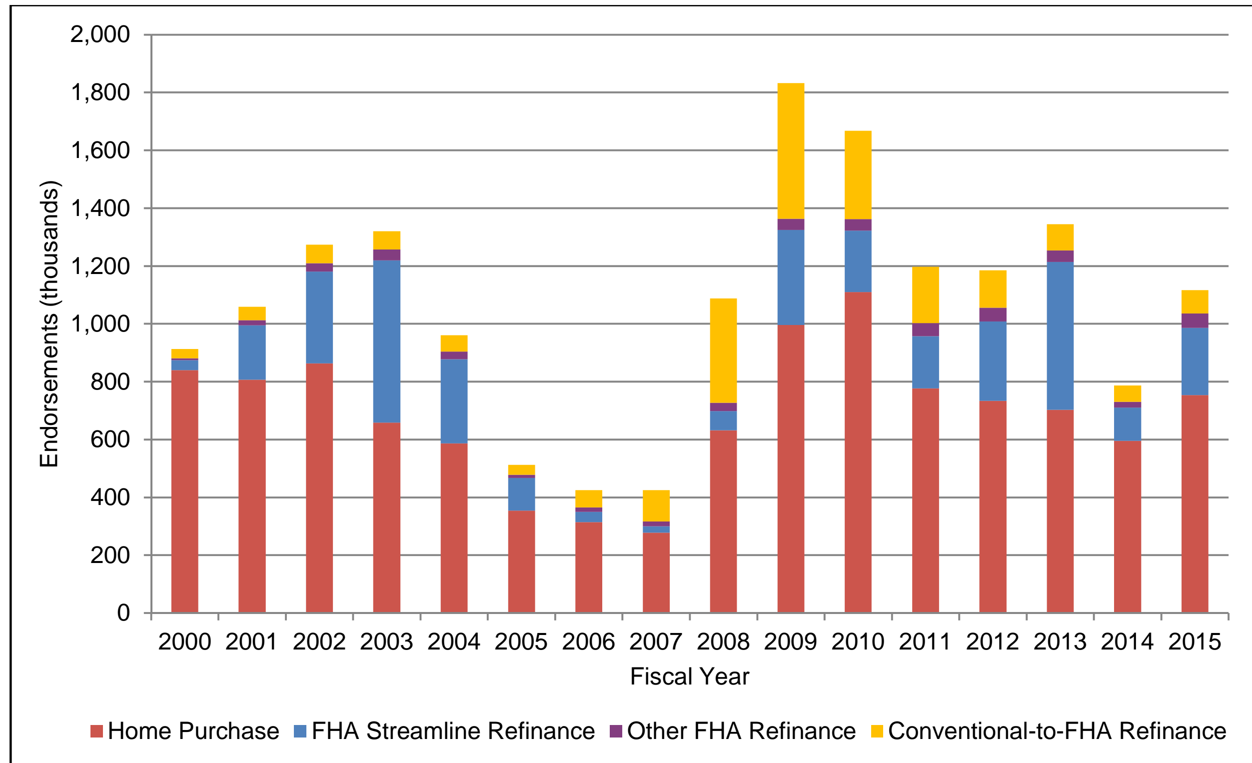
Exhibit 1

Distribution of FHA Single Family Forward Endorsements by Loan Type

[1] http://www.census.gov/construction/nrc/index.html

[2] http://www.reuters.com/article/us-usa-economy-homes-index-idUSKCN0V41PQ

[3] Historically, the share of total mortgages originated by FHA has averaged about 13 percent of total mortgage originations, but market share has fluctuated with economic disruptions. Since World War II, there were four instances in which FHA's market share ballooned by more than 5 percent in a year: 1948, 1958, 1970, and 2008—years that coincided with periods of economic recession, according to the National Bureau of Economic Research. (http://www.huduser.org/portal/Publications/pdf/HUD-FHAAT80.pdf)



SOURCE: U.S. Department of HUD/FHA, October 2015.

Borrower Characteristics

With its low down-payment requirement, FHA has served as a pathway to homeownership for first-time homebuyers. This has been especially true in recent years, as credit restrictions and higher financing costs have impeded many potential borrowers, including those that would previously have been served by the conventional market. In FY 2015, 82 percent of all FHA purchase originations were to first time homebuyers – a total of 614,148 loans. This is consistent with FHA's endorsement trends over the past 15 fiscal years, during which approximately 80 percent of annual purchase endorsements were for first-time homebuyers. ***Over the course of its 81-year history, FHA has funded approximately 13 percent of total market mortgage originations but more than 50 percent of all first-time homebuyer market purchase mortgages.***[4]

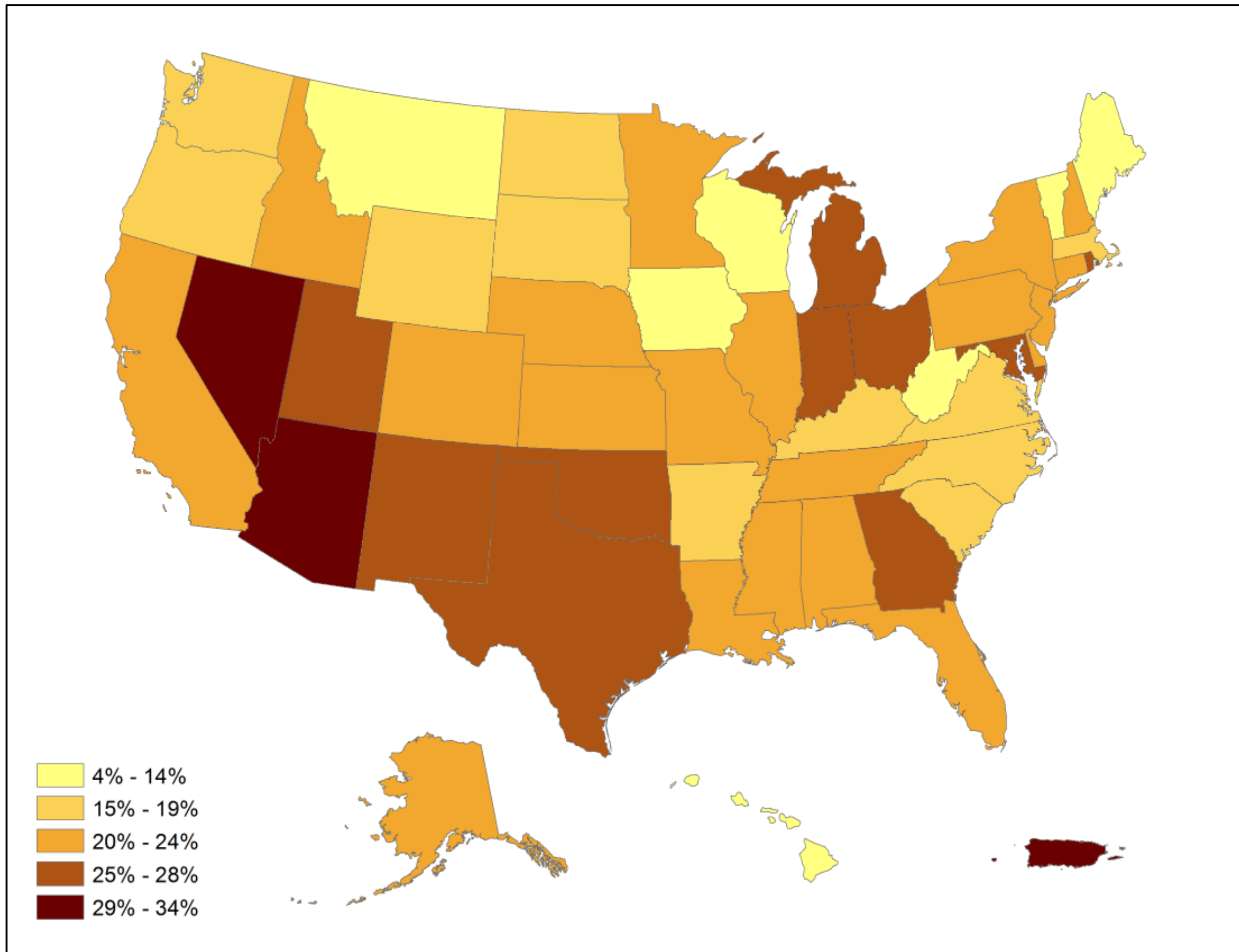
In FY 2015, a third of FHA mortgages went to minority buyers, consistent with long-term trends. The proportion of FHA purchase endorsements to Hispanic and African-American borrowers remained steady at around 17 percent and 11 percent respectively. Given that minorities are projected to drive new household formation and home sales over the next decade, FHA continues to closely monitor demographic trends to ensure its ability to serve all qualified borrowers.

Geographically, FHA served borrowers in every state in the country, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Because credit policies and premiums do not vary by geography, FHA

[4] http://www.huduser.org/portal/Publications/pdf/HUD-FHAAT80.pdf.

provides a stabilizing force across jurisdictions, ensuring broad credit access during localized downturns. State-level data on FHA purchase endorsements, as measured by loan counts, are mapped below for 2014, the most recent year for which data is available.

Exhibit 2
FHA Purchase Endorsements as a Proportion of Total State Purchase Originations, CY 2014



SOURCE: HMDA, 2014[5].

Many of the states with the highest proportion of FHA purchase activity are in the Southwest. In 32 states, FHA-insured loans represented at least 20 percent of all purchase activity. In 12 states and Puerto Rico, FHA-insured lending made up a quarter of all 2014 purchase lending. Nevada, Puerto Rico, and Arizona were the states that relied most heavily on FHA purchase activity in 2014, with FHA-insured loans endorsing 34 percent, 33 percent, and 31 percent of all purchase loans in those places, respectively. In contrast, only two states, Vermont and Hawaii, had FHA-insured lending account for less

[5] Home Mortgage Disclosure Act data publication lags a year behind the calendar year. Presently, the most recent available data is from CY 2014.

than 10 percent of annual purchase originations. In Hawaii, FHA-insured loans were just 4 percent of total purchase originations, likely reflecting the state's high housing costs.

Economic Net Worth

The independent actuary reports that the MMI Fund's economic net worth (ENW) has improved by $19 billion since last year, increasing from $4.8 billion in FY 2014 to $23.8 billion in FY 2015. This continues a strong positive trend; the Fund has improved a total of $40 billion since FY 2012. The MMI Fund required capital ratio similarly improved by 3.5 percentage points over that time, from *negative* 1.44 percent to *positive* 2.07 percent. Improved policies and risk management, discussed below, have contributed to these positive trends.

The Independent Actuary's FY 2015 predictions show that the MMIF's ENW is expected to continue to grow in 2016 – finishing the year at 2.77 percent.

Portfolio Metrics Demonstrate Improvement

The underlying fundamentals of the portfolio are strong and show positive performance—improvements in the credit quality of new production, reduced delinquencies, and higher recoveries on distressed assets all speak to the better credit quality of recent loan vintages and improved asset management.

The better credit quality of new business is reflected by improved early payment delinquencies (EPD) rates. The EPD rate is the rate at which loans experience 90-day delinquencies within the first six months of origination. EPD rates provide the first indication of potential credit performance of newly insured loans and are a leading indicator of the long-term claim risk of a particular book of business. Consistently low EPD rates throughout FY 2015 illustrate the sustainability of the recovery in the portfolio. Newer books of business have vastly outperformed those insured in crisis years. EPD rates for the FY 2010 through February 2015 vintages are less than 20 percent of the EPD rates for the FY 2007 and 2008 vintages.

Seriously delinquent loans—those that are 90 or more days past due—also offer an important window into the performance of the portfolio, and demonstrate continued improvements in FY 2015. Over the last four years the serious delinquency rate has fallen by 35 percent, a nearly $35 billion reduction in the size of the seriously delinquent portfolio. Because of this significant reduction, for the first time since the beginning of the crisis, the number of existing FHA borrowers who cure their seriously delinquent loans is equal to the number of new borrowers who become seriously delinquent – a net zero for new serious delinquencies in [FY 2015].

Recoveries on defaults are a third metric that offers valuable insight into the health of the portfolio. In FY 2015, FHA continued its focus on further reducing loss severities associated with the legacy book—developing and executing against an overall asset management strategy targeted at keeping borrowers in their homes when possible, and maximizing recoveries when that was not the case. Since 2013 claim

recoveries have improved 43 percent which contributed more than $3 billion to the MMI Fund during that time.

As the performance of the portfolio continued to improve, FHA was able to examine its premium pricing structure and weigh it against the need for expanded, affordable access to credit in the market.

III. Impacts of Forward Mortgage Insurance Premium Reduction

Last January, FHA announced a reduction in the annual mortgage insurance premiums (MIP) on Single Family forward loans to support access to affordable mortgage credit. This expanded the work begun under FHA's *Blueprint for Access* initiative. FHA's decision to reduce its premiums was influenced by conditions in the broader housing finance market which was still experiencing long-term constrained credit, particularly for first-time homebuyers, low- and moderate-income households, and those recovering from the effects of the Great Recession. The reduction was, and is, intended to ease the path to responsible homeownership for hardworking Americans.

When the MIP reduction was announced, FHA communicated to stakeholders that the action was expected to introduce 250,000 new borrowers into the market over a three-year period, an average of roughly 83,000 per year. This new activity would come from previously underserved potential borrowers – best represented as those with credit scores at or below 680.

From FY 2014 to FY 2015, the number of purchase endorsements increased by 27 percent—growing from 594,997 purchase loans in FY 2014 to 753,389 in FY 2015. Refinance activity, which had declined sharply in FY 2014, rebounded by 90 percent between FY 2014 and FY 2015. Much of this growth was driven by the MIP reduction and continued low interest rates. In the first twelve months since the MIP reduction 106,000 additional borrowers with credit scores at 680 or below received an FHA loan, exceeding initial projections. These everyday Americans are now experiencing the many benefits of affordable homeownership.

To responsibly manage the Fund, the MIP pricing structure for forward loans must appropriately cover FHA's credit risk exposure and contribute to a capital reserve. Concerns were raised as to whether the premium reduction was appropriate, given the state of the MMIF's capital reserve at the time of the announcement. The work of the independent actuary indicates the MIP reduction had limited impact on the capital ratio and did not alter the strong positive trajectory of the fund's capital. In fact, since the introduction of the MIP decrease the independent actuary slightly *increased* the rate it projects the forward loan portfolio to accrue its capital cushion. The MIP decrease did not compromise the capital cushion or affect FHA's ability to pay expected future claims, and the Fund surpassed the 2 percent capital reserve benchmark in FY 2015.

While achieving the 2 percent capital ratio target represents a crucial milestone for FHA, managing the Fund goes beyond achieving a minimum capital ratio at a particular point in time. FHA's decision to reduce premiums created the opportunity for more than 100,000 families to become homeowners and further bolster our nation's housing market.

IV. Improve and Strengthen FHA

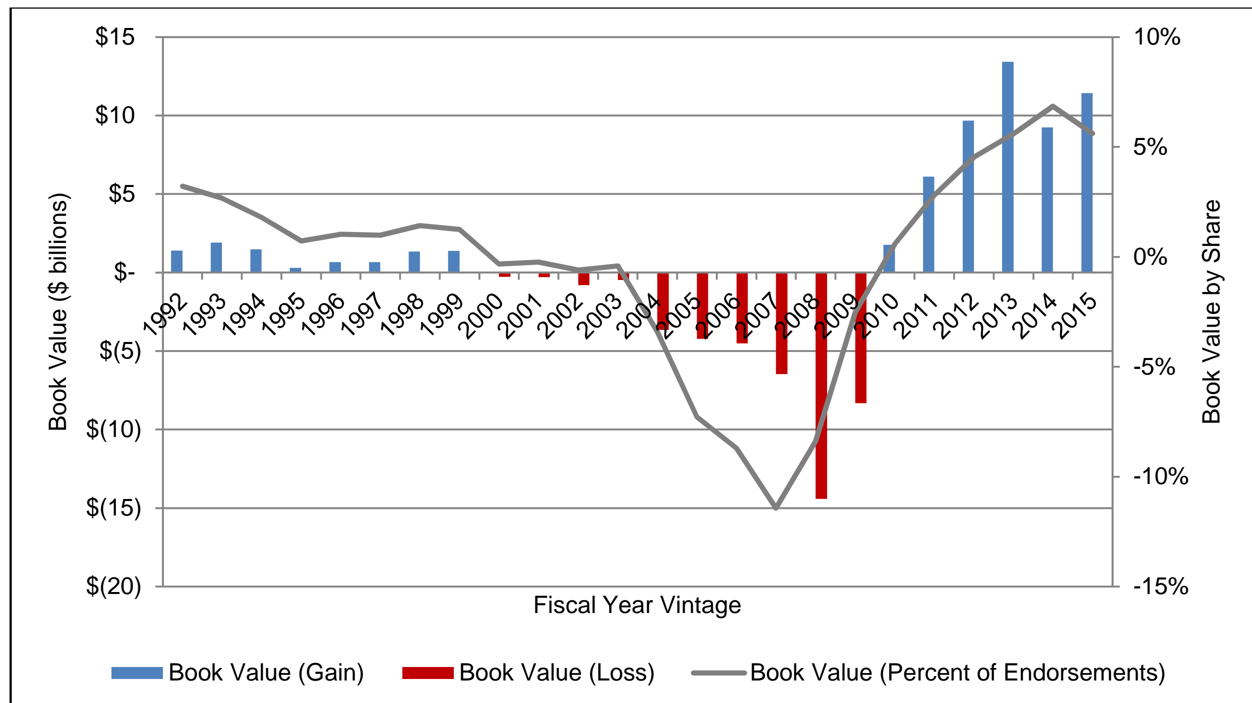
In the years since the crisis began, FHA has made substantial changes to its credit guidelines in improve and strengthen the position of the Fund. FHA relies on risk-based underwriting policies that discourage extreme risk layering, but also recognizes that otherwise underserved borrowers can be creditworthy borrowers when compensating factors are considered. Many steps taken by FHA to improve underwriting standards are already having positive impacts while preserving critical access to credit for those borrowers.

FHA uses its Technology Open to All Lenders (TOTAL) Scorecard to rank borrowers by credit risk, based on many indicators, including credit scores, reserves, and income ratios. In 2013 FHA broadened the group referred for manual underwriting by TOTAL to ensure better risk management. To further align credit standards with acceptable risk levels, FHA also implemented changes such as:

- Instituting a 10 percent down payment requirement on loans with credit scores less than 580.
- Strengthening manual underwriting guidelines to discourage extreme risk layering.
- Working with Congress to end risky seller-funded down-payment assistance practices.

These changes significantly improved the quality of FHA's incoming business, and slowly but steadily increased the value of the Forward portfolio. While the overall effect of any individual vintage year on a $1 trillion portfolio is limited, a steady accumulation of high-quality loans over several years improves the Fund. The 2005–2008 loan vintages that account for the bulk of FHA's more recent losses now represent only 10 percent of the Forward portfolio with more recent loans performing at or above expectations.

Exhibit 3
Book Value by Vintage, FY 1992–FY 2015



SOURCE: FY 2015 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

In FY 2015 FHA continued its efforts to strengthen the health of the Fund, especially through better risk management and loss mitigation practices. FHA's work on the *Blueprint for Access* has the three pronged benefits of improving clarity, compliance, and access to credit. FY 2015 saw the advancement of several major components of the *Blueprint.*

FHA published its Loan Quality Assurance framework, colloquially referred to as the "defect taxonomy," significantly ahead of actual implementation, giving industry substantial time to consider updates or modification to its own internal quality control practices. This allows both FHA and lenders to identify systemic problems sooner and correct them. FHA has begun to make necessary systems changes to implement the taxonomy into a new Loan Review System (LRS).

The Supplemental Performance Metric (SPM) is another effort to clarify policy and provide additional information with which to judge lender performance. As a complement to FHA's Compare Ratio, the SPM compares a lender's performance to an acceptable performance level for an FHA portfolio of loans with the same credit score mix in three distinct credit score bands. This increases clarity and transparency and helps those using the Compare Ratio as a proxy for acceptable performance understand the impact that performance by credit score band has on FHA's overall assessment.

FHA also made considerable progress on its Single Family Housing Policy Handbook, which brings together hundreds of pieces of separate, but related policy guidance documents in a user-friendly format. By releasing completed sections incrementally, FHA is allowing the industry to familiarize itself with the organizational changes in the handbook and understand additional requirements before they become effective. The majority of the updated Handbook is now publically available and several sections are already effective.

Looking ahead to FY 2016, FHA plans to finish work on the LRS and the Handbook – making expectations clear, compliance more accessible, and access to credit more broadly available.

V. HECM

Since Forward loans comprises the vast majority of the MMIF, much of FHA's efforts focus on the policies and performance of that portfolio. However, it has become clear in recent years that the HECM portfolio, as part of the MMIF, has a significant impact on value relative to size. As such, a discussion of the role and performance of the program is warranted.

Role and Importance

FHA pioneered the development of the HECM program in 1989, and continues to facilitate the reverse product by providing insurance that protects lenders and investors from losses. Since its inception, more than 1 million seniors have been able to age in place while gaining access to the equity they had built in their homes over time. While the program represents only a small fraction of the total endorsements in the MMIF each year, it is an important option for homeowners aged 62 and older, many of whom lack a stable source of income for living expenses and other financial needs. FHA's role helps ensure that there are appropriate housing finance options are available at every stage of life.

FHA's HECM program is unique in the market – FHA is the only widely-available source of reverse mortgage insurance at a time when the U.S population is aging. In the wake of an economic crisis that altered the long-term financial plans of many Americans, maintaining the availability and viability of this program has never been more important.

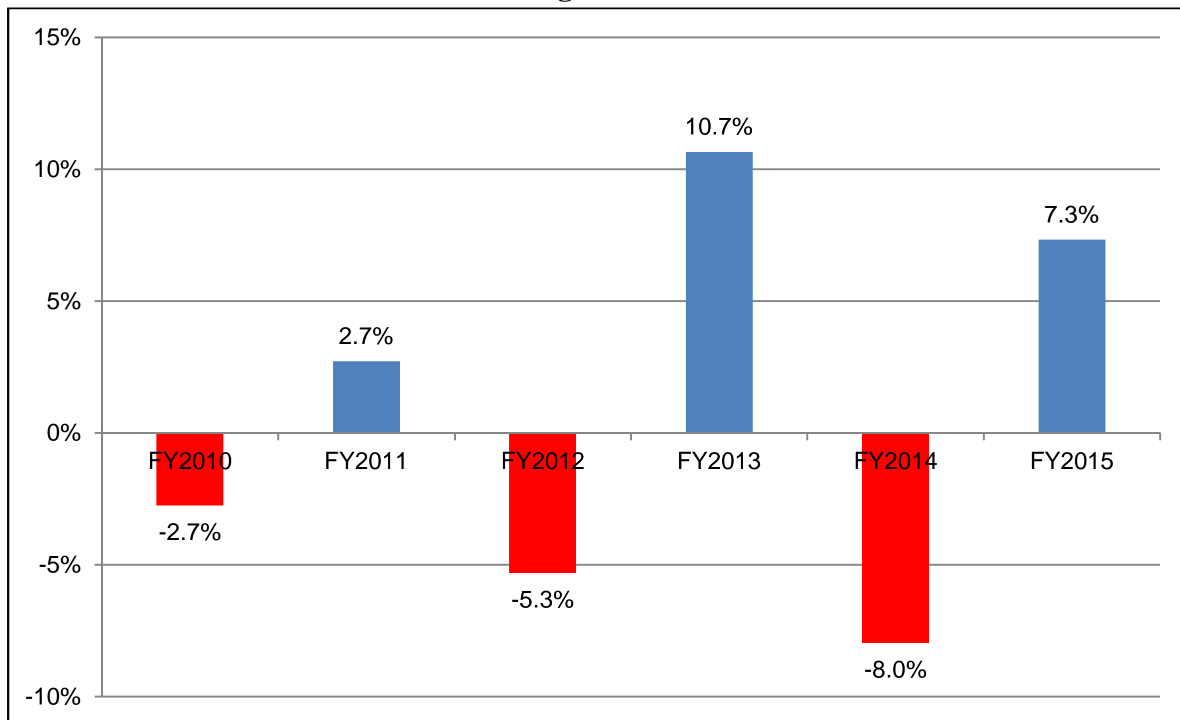
In FY 2015, FHA's HECM program helped 57,990 senior households to age in place, an increase of 6,374 borrowers from FY 2014. In FY 2015, 39 percent of HECM borrowers were single females and 22 percent were single males, and multiple borrowers comprised 39 percent of HECM borrowers, the same level as FY 2014. Additionally, the borrower's average age has declined, from approximately 77 in FY 1990 to around 72 in FY 2015. However, roughly 46 percent of HECM borrowers were between the ages of 62 and 69 in FY 2015, a decrease from 50 percent in FY 2013 and 48 percent in FY 2014.

HECM Modeling and Variability

While the overall performance of the MMIF is strong and continuing to improve – it is important to acknowledge areas where results are more variable. In contrast to the Forward portfolio, which has steadily improved in value over the last three years, HECM valuations, while strong this year, have exhibited more variability. Since the program is dependent on the market value of the property used as security, the HECM portfolio can experience significant swings in value year over year as the market factors that influence the present value of future home price change. The changes in these market factors, in turn, alter the projected losses on and values of loans in the portfolio.

Exhibit 4

HECM Year-over-Year Change in Value as Percent of HECM IIF



SOURCE: FY 2010–FY 2015 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

Two unique HECM characteristics are primarily responsible for the sensitivity of HECMs to changes in economic assumptions.

1. HECMs are characterized by a significantly longer Weighted Average Life than standard mortgages (over 15 years for HECMs versus about 6 years for Forwards). Longer maturities mean greater discounting and greater sensitivity to changes in interest rates over time.

2. While FHA serves solely as guarantor for the Forward portfolio, in the HECM market FHA is more likely to own the proceeds of selling the house, making house price appreciation a major consideration in the value of the portfolio. Additionally, since HECM lenders can assign loans to FHA when the unpaid principal balance reaches 98 percent of the maximum claim amount, ownership transfers to FHA, leaving FHA holding the asset.

Programmatic Changes

Despite these challenges, the HECM program itself is fundamentally sound – in part due to the assistance that FHA received from Congress. In 2013, FHA obtained authority to make critical changes to make the program more sustainable for the MMIF and to better serve consumers. As a result, FHA has issued considerable guidance to ensure the sustainability of HECM for borrowers and initiated new requirements to better manage FHA's risk.

Policy changes supporting that goal included limiting the amount that borrowers can draw at closing, changing MIP structure to support lower draws at closing and limiting Fixed Rate loans to one lump sum draw at closing. In addition, FHA introduced new Principal Limit Factors, including factors for eligible non-borrowing spouses under 62 who became eligible for a due and payable deferral period allowing them to remain in the home after the death of the mortgagor.

Now, with the benefit of two years of data, FHA can see that these changes appear to behaving positive results. These policies have successfully shifted the mix of Fixed Rate to Adjustable Rate HECM products. The mix of originations has shifted from 70 percent Fixed Rate and 30 percent Adjustable Rate between FY 2010 and 2012 to 16 percent Fixed Rate and 84 percent Adjustable Rate. Unlike in the Forward loan market, HECM ARMs pose less risk to the MMIF, as a drawdown of funds will take place at the current market rate rather than a rate locked in at the time of origination. This accounts for changes in market conditions and has little effect on the borrower, since they are receiving funds rather than paying them.

The initial equity draw patterns have also changed significantly: in 2013, 46 percent of borrowers drew 60 percent or less of the available HECM proceeds at close compared to 65 percent of borrowers in 2015. Preliminary data on draw patterns indicates that limiting draws during the first 12 months of the loan (a policy implemented in FY 2014) does not lead to larger draws after the first 12 months. This data suggests that reducing the amount borrowers can take on early could improve their capacity to use home equity when they might need it most.

During FY 2015, FHA continued its work on critical HECM policy changes and rulemaking. For the changes to the Financial Assessment and Property Charge requirements, extensive industry outreach and training have been, and continue to be, critical to effective execution. The goal of this outreach and training is to help lenders determine the capacity of borrowers to meet their documented financial

obligations and comply with the HECM provisions – understanding whether the HECM is a sustainable solution. FHA has also worked to address important issues surrounding non-borrowing spouses who live in insured HECM properties. These changes ultimately addressed the narrow issue of helping spouses not on the loan to stay in their homes and were well received by industry and the public. However, challenges in ensuring seniors will be successful with HECMs remain and HUD continues to further examine how to reduce the negative effects of tax and insurance defaults which can lead to foreclosure for seniors. Updates to its required housing counseling program and the creation of additional opportunities for lenders to offer loss mitigation to eligible HECM borrowers are two options currently being pursued.

FHA feels that it has effectively responded to the programmatic issues affecting the loan level performance of HECM. Improvements like the provision of greater lender flexibility to use loss mitigation for eligible borrowers, limiting the amount of money that can be taken from the property, and removing riskier HECM product options, appear to have proven useful in reducing losses to the Fund.

VII. Conclusion

FHA remains committed to ensuring that the housing market is strong and sustainable – one with the right kind of housing opportunities for all Americans. By taking proactive steps and focusing on smart risk management FHA has been able to restore the health and stability of the Fund, making sure that it will be there for the next generation of homeowners. As FHA emerged from the economic crisis, discussions of the health of the MMI Fund rightfully focused on the prospects of the Forward portfolio and its performance. In recent years, it has become clear that the future health of the Fund also depends on the progress of the HECM portfolio. FHA is looking forward to working with Congress and its industry partners to make progress on better understanding the benefits and risks of the HECM program.