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Hearing before the Committee on Banking, Housing and Urban Affairs

United States Senate



“Modernization of Federal Housing Administration Programs”

July 18, 2007

Thank you Chairman Dodd, Ranking Member Shelby for inviting me to testify on the Administration's proposal to modernize the Federal Housing Administration. All of us appreciate the priority you have given to this legislation.

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

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

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

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

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 In recent years, FHA's outdated statutory authority has left the agency out of synch with the rest of the lending industry.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

As a result, FHA's volume has dropped precipitously in housing markets all across the nation. For example, in Senator Reed's home state of Rhode Island, FHA's volume dropped from 3,110 loans in FY 2001 to just 385 loans in FY 2006 – a decline of 88 percent or \$256 million. For Senator Martinez, Florida saw its loan volume drop 79 percent, from 55,524 loans to 12,091, resulting in a loss of \$3.25 billion. And any discussion of FHA volume would be incomplete without a mention of California, which

until recently led the nation, but has now seen its loan volume drop from 109,074 to just 2,599; that's a decline of 98 percent and a loss of \$13.6 billion.

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

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

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

Some homebuyers, especially those in high home cost states like California, turned to high-cost financing and nontraditional loan products to afford their first homes. While low initial monthly payments may have seemed like a good thing at the time, the reset rates on some interest-only loans are substantial and many families have been and will continue to be unable to keep pace when the payments increase. In addition, prepayment penalties often times make refinancing cost-prohibitive. According to *Mortgage Strategist*, more than \$2 trillion of U.S. mortgage debt, or about a quarter of all mortgage loans outstanding, is due for interest rate resets in 2007 and 2008. While some borrowers will make the higher payments and many others will refinance, some will struggle and some will be forced to sell or lose their homes to foreclosure. And I think we can all agree that foreclosures are bad for families, bad for neighborhoods, and bad for the economy as a whole.

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

Moreover, the FHA bill proposes changes that will strengthen FHA's financial position, improving FHA's ability to mitigate and compensate for risk. The proposed changes would permit FHA to price its products commensurate with the risk, as opposed to having some borrowers pay too much and some too little. Imagine if a car insurance company charged all clients the same premium – the 17-year-old teenager and a 40-year-old adult would pay the same rate. Is that fair? With a blended rate, those who know they're paying too much switch to another insurance company. That leads to a portfolio that is increasingly lopsided: too many riskier borrowers, too few safer borrowers that

collectively pose greater risk to an insurance fund. This scenario, known as adverse selection is exactly what happened to FHA over the last decade. Those who were lower credit risks went elsewhere. The premium changes proposed in the Administration's proposal will restore balance to the FHA funds, providing appropriate levels of revenue to operate in a more fiscally sound manner.

While we are on the topic of the soundness of the insurance fund, I am proud to report that the Office of the Inspector General found no material weaknesses in its FY 2006 audit of the FHA, and that in January 2007, the GAO removed FHA's single family mortgage insurance programs from its high risk list – where we had been since 1994. Both of these developments reflected improvements that HUD has made in recent years in its management of property disposition contractors, its oversight of lenders, its implementation of a mortgage scorecard, and its ability to predict claims and estimate credit subsidy costs.

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

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

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

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

soundness of the FHA Fund and creating incentives for borrowers to achieve good credit ratings and save for downpayments.

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

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

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

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

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

Another change proposed in FHA Modernization is to increase FHA's loan limits. Members of Congress from high-cost states have repeatedly asked FHA to do something

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

We are proposing to manage the Fund in a financially prudent way, beginning with the change in FHA pricing to match premiums with risk. This will avoid FHA being exposed to excessive risk, as it is today, because some borrowers who use FHA are under-charged for their risk to the Fund while those who are overcharged are fleeing from the program. Of course, we will continue to monitor the performance of our borrowers very closely, and make adjustments to underwriting policies and/or premiums as needed.

I know I've talked a lot here today, but I want to convey to you how passionate I am about the proposed changes. I believe we have an opportunity to make a difference in the lives of millions of low- and moderate-income Americans. We have a chance to bring FHA back into business, to restore the FHA to an innovative role. And when people ask me why we are proposing these changes, I tell them these exact words: "Families need a safe deal, at a fair price. Families need a way to take part in the American Dream without putting themselves at risk. Families need FHA."

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