



Written Testimony

of

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**“Addressing FHA’s Financial Condition and Program Challenges Part II”**

before the

**Senate Committee on**

**Banking, Housing, and Urban Affairs**

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## 1. Introduction

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, I thank you for the opportunity to testify today about the Federal Housing Administration's (FHA) current financial condition and the challenges that the agency faces in the aftermath of the housing crisis.

I am Sarah Rosen Wartell, president of the Urban Institute. For 20 years, I have worked on housing finance policy issues. I began my career in public policy with a five-year stint as an official at FHA, advising FHA Commissioner Nicolas Retsinas and HUD Secretary Henry Cisneros on housing finance, mortgage markets, and consumer protection. I held a variety of positions at FHA including deputy assistant secretary for operations and associate general deputy assistant secretary for housing, and I helped develop a 1995 proposal (never adopted by Congress) to transform FHA into "a results-oriented, financially accountable [government corporation known as the Federal Housing Corporation that would] utilize the strengths of private market partners to expand homeownership opportunities, ...[while continuing] to serve the needs of working families who require low-downpayment loans, and residents in central cities, older neighborhoods, and other underserved markets, and develop more affordable rental housing."<sup>1</sup>

After HUD and my subsequent tenure as deputy assistant to the president at the National Economic Council in the White House, I served as a consultant to the bipartisan Millennial Housing Commission, where I wrote about how FHA faced management weaknesses and growing risk with inadequate risk management tools. I proposed single-family risk-sharing as one potential strategy to help FHA protect taxpayers while serving its mission more effectively.<sup>2</sup> Later, in 2007, at the Center for American Progress, I convened the Mortgage Finance Working Group, a cross-sector coalition of individuals working to understand and develop policy responses to the emerging mortgage market crisis. Now, at the Urban Institute, I am responsible for leading an organization that provides research and analysis on a wide array of issues, from tax policy to community development to health care and more. The Institute is working to launch a new research initiative with the capacity to provide data and independent analysis to inform policymakers on housing finance questions.

This testimony describes the role that FHA has played historically and during the most recent financial and housing market crises. As the Committee requested, I also look at the origin of

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<sup>1</sup> "Reinvention," by Henry Cisneros, June 29, 1995, available at <http://archives.hud.gov/remarks/cisneros/whyhud/reinvent.cfm>.

<sup>2</sup> Sarah Rosen Wartell, "Single-Family Risksharing: An Evaluation of Its Potential as a Tool for FHA," June 2002, available at <http://govinfo.library.unt.edu/mhc/papers.html>.

losses expected from the FHA insurance portfolio. In short, these losses stem in part from specific products that proved costly and FHA's difficulty in quickly identifying and shutting down problematic originators and underperforming servicers; however, these losses stem in larger part from rapidly falling home values amidst a foreclosure crisis and job losses arising from the deepest recession in many, many decades.

In short, many of these costs are inevitable—the result of FHA playing an indispensable countercyclical role, without which losses to the U.S. economy, U.S. homeowners, and U.S. taxpayers through the conservatorship of Fannie Mae and Freddie Mac would have been far greater. But some of these costs might have been avoided if FHA had more analytic capacity and additional tools and authorities to act nimbly to manage, price, and mitigate risk.

Looking forward, the Fund's capital reserve must be replenished. And FHA's role can be more targeted to supporting lower-wealth, moderate-income families through the reduction of loan limits. Congress also can enhance FHA's capacity to act quickly to reduce the level of defaults and the severity of losses. I will describe some of the steps that could be taken that would give FHA officials the ability to act quickly to make programmatic changes that would reduce losses. These steps offer good prospects for further reducing risks to the Fund and protecting taxpayers now and in the future.

At the same time, I caution against extreme measures that would prevent FHA from serving its core missions: (1) providing the critical countercyclical backstop necessary to break a vicious cycle of housing market decline and the accompanying flight of private capital; and (2) ensuring access to credit for credit-worthy borrowers who have limited private-market options. And I argue that we cannot answer some critical questions about FHA's role in a vacuum without understanding the shape of the mortgage finance system after the conservatorship of Fannie Mae and Freddie Mac comes to an end and the government's role in the conforming market is scaled back.

## **2. The Historic and Recent Role of FHA**

FHA has played a critical role over the years in promoting sustainable homeownership. Before the creation of FHA, families put off homeownership until they had accumulated sufficient wealth to buy a house outright or to borrow just a small fraction of the funds. Balloon payments were typical, so interest rate shifts could mean the inability to refinance and the loss of a home. As a result, homeownership, with its many positive societal benefits, was delayed and often never realized.

At the time FHA was created in 1934, the homeownership rate stood at approximately 46 percent. FHA demonstrated that, with proper underwriting and due care not to layer risk, those with very little wealth but steady employment could responsibly borrow money to purchase a

house. FHA pioneered the long-term, self-amortizing, low-down payment mortgage that allowed millions of American families to afford homeownership. Partially as a result of FHA, homeownership rose to almost 63 percent by 1970.

The research literature shows that homeownership correlates with improved outcomes for children, reduced crime, and higher civic participation. Homeownership is still the primary form of wealth creation for middle-class families. For families in the middle income quintile, approximately half of net worth is from housing equity.<sup>3</sup> Families that delay homeownership by ten years will have, on average, \$42,000 less in net assets at retirement.<sup>4</sup> At the same time, of course, foreclosure is adversely correlated with surrounding home values and outcomes for children and crime.<sup>5,6</sup> In other words, sustainable homeownership has positive benefits, but indiscriminate homeownership does families and society no favors. The goal must be a balanced policy offering affordable and family-friendly rental housing options along with “homeownership done right” for those ready and eager to sustain a mortgage.

While FHA mortgages total roughly \$1 trillion of the \$10 trillion mortgage debt outstanding, or approximately 10 percent of the market by dollar, the program plays a disproportionate role among first-time homebuyers. Historically, FHA served approximately half of first-time homebuyers. Recently, it has been closer to three-quarters.<sup>7</sup>

In addition to supporting first-time homebuyers, FHA serves markets that have historically been either underserved or poorly served by private markets. The availability of refinancing and the ability to “trade up” and purchase subsequent homes are important ways in which limited wealth is acquired in minority and underserved communities. In 2010, FHA-insured mortgages accounted for nearly 60 percent of all originations among African-American and Hispanic households, compared to 33 percent among all white households. Similarly, FHA-insured mortgages are more likely to be in communities with below-median income.<sup>8</sup> When the private sector serves these markets, it has often been with subprime mortgages with default rates significantly higher than those of FHA-insured mortgages; these mortgages have led to loss of homes at an alarming rate.

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<sup>3</sup> Mauricio Soto, “Family Net Worth before the Recession,” The Urban Institute, March 2010, available at [www.urban.org/publications/412078.html](http://www.urban.org/publications/412078.html).

<sup>4</sup> Roya Wolverson, “Rent Nation,” *TIME*, September 24, 2012, p. 52 (citing Signe-Mary McKernan, whose calculations are based on Gordon B.T. Mermin, Sheila R. Zedlewski and Desmond J. Toohey, “Diversity in Retirement Wealth Accumulation,” The Urban Institute, December 2008, available at [www.urban.org/UploadedPDF/411805](http://www.urban.org/UploadedPDF/411805)).

<sup>5</sup> “Do Foreclosures Cause Crime?” Furman Center for Real Estate & Urban Policy, February 2013.

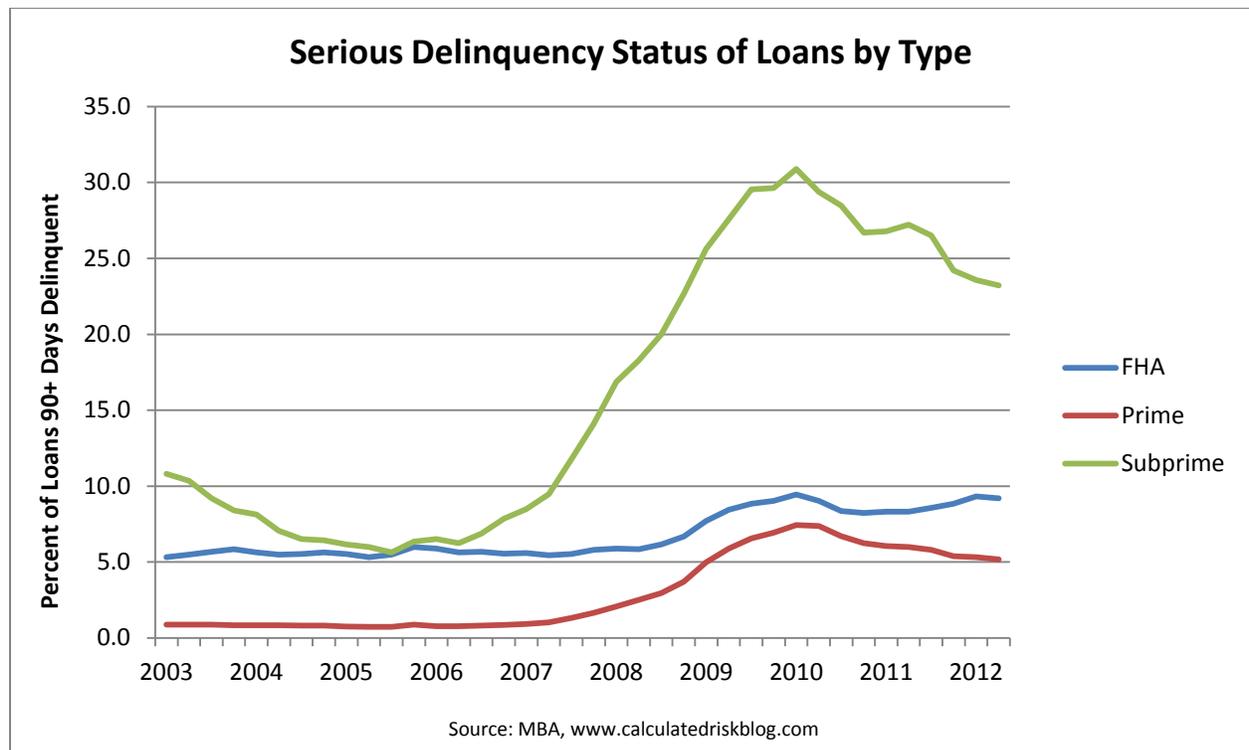
<sup>6</sup> Atif Mian, Amir Sufi, and Francesco Trebbi, “Foreclosures, House Prices, and the Real Economy,” National Bureau of Economic Research working paper, May 2012.

<sup>7</sup> Edward Szymanoski, William Reeder, Padmasini Raman, and John Comeau, “The FHA Single-Family Insurance Program: Performing a Needed Role in the Housing Finance Market,” U.S. Department of Housing and Urban Development working paper, December 2012.

<sup>8</sup> Ibid.

This point is worth emphasizing: while FHA defaults are too high right now, its default rates are still well below the subprime lending originated in the last decade principally with private-label securitization. (See Figure 1.) Thus, when FHA serves communities of color and minority homebuyers, the outcomes have typically been better than when the private market did so without government support. To be clear, I am not saying that the performance is good enough. Unfortunately, at times realtors and others steered borrowers to FHA-insured mortgages and originated loans with too little focus on capacity to repay, with adverse implications for not only the individual borrowers, but the communities as well. We must continue to strive to improve the performance of FHA lending, for the benefit of the homeowners, their communities, and the taxpayers. But we also must recognize that—absent FHA—availability of credit, homeowner equity, and community stability in many underserved communities would be even more limited.

**Figure 1**



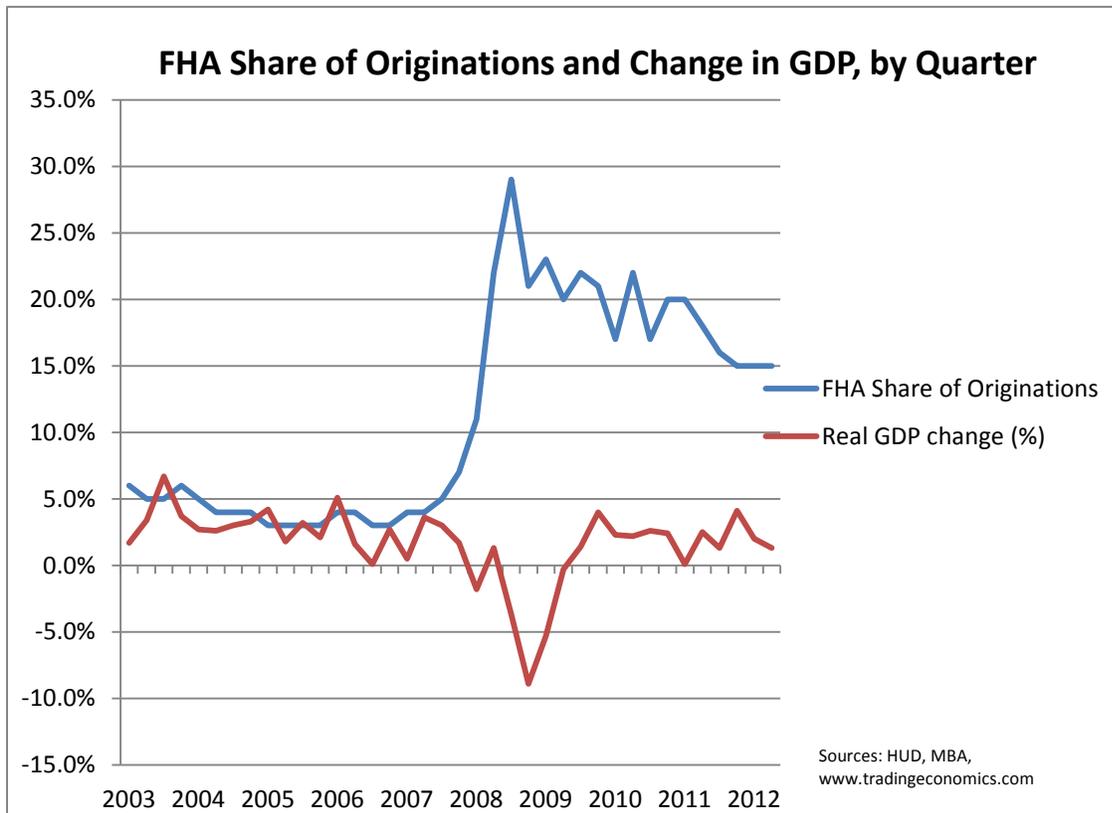
FHA’s role as a provider of credit to minority and underserved borrowers could prove especially important given changing demographics, unless the private market proves more adept at serving these homebuyers. The housing market will be ever more diverse, with minorities expected to make up 70 percent of new net households over the decade.<sup>9</sup>

<sup>9</sup> Alejandro Becerra, “The 2011 State of Hispanic Homeownership Report,” National Association of Hispanic Real Estate Professionals, March 2012.

In addition to promoting homeownership, FHA plays a critical role as a countercyclical force in the housing market and economy. Figure 2, which plots FHA’s market share and GDP growth, demonstrates starkly this countercyclical role. When credit markets are booming and credit spreads are low, FHA’s market share naturally shrinks. The funding advantage that FHA/GNMA has over the private market is much lower during good times. Furthermore, the administrative challenges of FHA lending are a disincentive to lender participation when there is ample private credit available.

During times of economic stress, however, private credit providers pull back as they eschew risk, and the share of FHA-insured lending grows. Then, as markets normalize and private lenders begin taking more risk and seeking greater returns, FHA market share falls again. As the recession moves further into the past, the FHA share will likely continue to fall. In the 1990s and early 2000s, FHA share typically ranged between 10 and 15 percent, but it fell to less than 5 percent in the years immediately preceding the crash. As of mid-2012, the share has settled back to around 15 percent.<sup>10</sup> Note that FHA policies tend to be relatively stable; it is the private sector that is either accelerating or decelerating.

**Figure 2**



<sup>10</sup> Ibid.

Given the extent of the hardship Americans have endured in recent years, it is difficult to imagine that the economic downturn could have been more severe if not for the stabilizing role that FHA played. Consider a homeowner who finds her income limited and can no longer afford her mortgage, or needs to move to another part of the country to find work or care for a relative. If credit continues to flow, other purchasers can buy the home, allowing the homeowner to recapture her equity and/or downsize without destroying her credit. But if lending to all but borrowers with pristine credits and high down payments disappears, the homebuyer cannot sell and the value of the home declines precipitously, leaving others in the neighborhood with lost equity. This outcome creates ripple effects throughout the community, ultimately affecting consumption and employment.

Economist Mark Zandi of Moody's estimates that, absent FHA-insured lending, home values might have fallen another 25 percent, resulting in 3 million more job losses and a reduction of economic output of \$500 billion.<sup>11</sup> By this estimate, the value of the housing stock would have fallen in total by half, not the third that it did fall.

In addition to serving an indispensable countercyclical role for the housing market in times of crisis, FHA played an important part historically in standard setting and testing new underwriting. Before the creation of FHA, mortgages were relatively short-term loans with the principal due at the end of the term. FHA introduced the idea of a self-amortizing long-term mortgage. FHA mortgages initially had a 20-year term. Now 15-year and 30-year products are standard for both FHA and the market. More recently, FHA has worked to set standards around reverse mortgages. Going forward, as we gain insight on how credit counseling can reduce mortgage risk, how alternative credit histories like rent and utility payments help predict loan performance, and how the availability of reserves and repair escrows improve loan performance, FHA could again play a role in piloting new prudent underwriting standards to gain sufficient evidence under various conditions to attract private capital to measure and price the risk appropriately.

FHA-insured mortgages, along with mortgages backed by the Veterans Administration (VA) and the Rural Housing Service (RHS), form the basis of GNMA mortgage-backed securities (MBS). These securities are valued by the capital markets for their liquidity—that is, the ability to trade large volumes at a market price at low transaction costs. This liquidity is the product of the full faith and credit guarantee, the standardization of product, and the scale or size of the market. The result is a market with low transaction costs and transparent prices. This liquidity benefits not only the investor, but also the borrower through lower mortgage rates. One study

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<sup>11</sup> Jesse Eisenger, "New Target in Finger-Pointing Over Housing Bubble," *New York Times*, January 9, 2013. <http://dealbook.nytimes.com/2013/01/09/new-target-in-finger-pointing-over-housing-bubble/>

suggested that interest rates fell by more than 50 basis points when GNMA securitization was introduced in the 1970s.<sup>12</sup>

The above discussion focused on FHA's role in the single-family mortgage market. FHA also plays a valuable role in the multifamily finance market. In this market, as well, FHA provides a countercyclical role, helps preserve housing units as affordable, and finances parts of the market that tend to be underserved, such as financing for apartments for low-income households.

### **3. Current State of FHA's MMI Fund**

The important roles that FHA plays in the housing market and the larger economy described above entails taking risk. FHA tries to price for that risk accurately to absorb costs under most likely circumstances but, like most housing market participants, it rarely gets it just right.

Like most insurance, during good times, the excess of premiums collected over the cost of claims builds up in the FHA fund, creating a capital reserve. But, low down payment mortgages will experience elevated defaults when house prices fall and unemployment rises. Given that we have seen the worst housing downturn since the Great Depression, we should not be surprised to see that defaults increased and the MMI Fund experienced significant outflows.

A few observations:

- The countercyclical nature of the FHA has helped. During most of the worst origination years in the market 2005 through 2008, FHA had relatively low volumes. Thus, although the performance of those books was poor, as it proved to be for most market participants, the absolute size of the losses was less than it would have been if the poor performing books of business were above average in size.
- The greatest net cost to the FHA Fund was at the pivot point—when private capital was fleeing the market and originators accustomed to generating lower-quality product looked for new outlets. Too much of that weak product ended up in FHA's portfolio before FHA could tighten its own standards. According to HUD reports, the worst years were 2007 and 2008:

The (single-family) books-of-business insured prior to 2010 are expected to generate large losses for the MMI Fund. The peak book for losses per-dollar of insured loans is 2007, the year that also has experienced the greatest total decline in home values. When that book is finally closed, its total cost is expected to exceed 11.3 percent of the initial dollar volume of loans insured. Though the 2008 book has a lower loss-per-dollar (7.7 percent), that book was three times as large as 2007,

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<sup>12</sup> Deborah G. Black, Kenneth D. Garbade and William L. Silber, "The Impact of the GNMA Pass-Through Program on FHA Mortgage Costs," *Papers and Proceedings of the Thirty Ninth Annual Meeting of the American Finance Association* 36, No. 2 (May 1981): 457–69.

and therefore, has expected dollar losses that are more than twice those of 2007 book (\$13.2 billion versus \$6.4 billion).<sup>13</sup>

- As standards tightened across the industry and FHA tightened its own rules, while private lender competition for high-quality credit borrowers disappeared, the credit quality in FHA's book of business grew tremendously. So newer books of business start to have net economic value for FHA, allowing it to begin to rebuild its capital. By 2010, early defaults had dropped dramatically and premium income had grown, leaving actuaries to predict that the economic value of the post-2009 books of business would speed the replenishment of the FHA fund.
- This phenomenon is typical of many insurance markets: the new books following the collapse are replenishing the fund. This *diversification across time* is an important element of insurance markets where there is high correlation of outcomes within the pool, such as property and casualty insurance. As former FHA Commissioner John Weicher, now of the Hudson Institute, tells the story, this pattern is very similar to that which FHA experienced in 1980 to 1982.<sup>14</sup>
- The increase in loan limits mandated by Congress also appears to have helped FHA to replenish the Fund. At a time when private capital and the GSEs were accepting only pristine credit with high down payments, higher LTV larger dollar loans for FHA appear to have strengthened the performance of the Fund.<sup>15</sup> As economic times improve and private capital returns, however, these non-mission-related, high-dollar insured loans should no longer flow into FHA's portfolio where they inflate the total amount of insurance exposure of the taxpayers, regardless of the economic value of those books of business.
- We learn (or relearn) from these periods that certain products and practices disproportionately contribute to loss. In general, reduced documentation, an abundance of second mortgages, and lax appraisals increase losses.
- In the case of FHA, seller-funded down payment assistance (SFDPA) and other seller contributions had much the same effect as second mortgages, which, along with lax appraisals, increased defaults in the program. For example, cumulative to date claim rates on the 2005 originations are over 20 percent when there was assistance from nonprofits

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<sup>13</sup> U.S. Department of Housing and Urban Development, *Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund, Fiscal Year 2012*, November 16, 2012, at 42-43.

<sup>14</sup> Presentation by John Weicher at the American Enterprise Institute, January 24, 2013, available at [http://www.aei.org/files/2013/01/24/-john-weicher-fha-presentation\\_110740723232.pdf](http://www.aei.org/files/2013/01/24/-john-weicher-fha-presentation_110740723232.pdf).

<sup>15</sup> U.S. Department of Housing and Urban Development, slidedeck on *Annual Report to Congress, Fiscal Year 2012 Financial Status FHA Mutual Mortgage Insurance Fund*, November 16, 2012, available at <http://portal.hud.gov/hudportal/documents/huddoc?id=111912FHAActRevPolResp.pdf>.

compared to a rate of 9 percent when there was no assistance.<sup>16</sup> The Actuary estimated that SFDPA loans reduced the economic net worth of the MMI Fund by \$15 billion. If FHA had never insured any SFDPA loans, the last actuarial report would have still shown a positive economic value for the Fund.

- The Home Equity Conversion Mortgage (HECM) program—the FHA program that first pioneered the reverse mortgage—has proven to be another major source of loss for FHA. When Ginnie Mae designed a securitization vehicle for HECMs in 2008, the product took off, with many lenders originating loans that allowed borrowers to take large cash amounts out of home value at one time, leaving them with limited resources to pay property taxes and other ongoing expenses. A well designed HECM converts home equity into an annuity at reasonable rates for living expenses. Performance of HECMs is especially vulnerable to home value fluctuations. FHA has tightened these standards significantly, but its authority to make changes is limited, and the slow pace of the rulemaking process necessary to return the program to its intended purpose has left the door wide open with FHA continuing to incur losses as program changes make their way through the regulatory process.

Three primary strategies exist to mitigate or manage mortgage risk and protect the taxpayer. They are (1) improving underwriting and quality control; (2) expanding loss mitigation efforts; and (3) adjusting mortgage insurance pricing and increasing revenue. FHA has taken steps in each of these areas and must continue to press forward with this agenda. Steps taken by FHA include:

- (1) **Improving underwriting and quality control:** In 2010, FHA eliminated seller-funded down payment assistance loans. It also imposed a 90 percent LTV limit for borrowers with FICO scores below 580, thereby increasing required down payments to avoid the most severe risk layering. They also improved lender and servicer performance standards through the development of a uniform seller-servicer contract. And FHA put in place “Neighborhood Watch”—an early warning system that, by comparing delinquency data for originators against others, allows them to identify and take action to bar from the program those lenders who are producing a disproportionate share of early defaulting loans. FHA seeks greater authority to see indemnification from many lenders as well.
- (2) **Expanding loss mitigation:** While the housing market is rebounding (it was reported this week that the Case-Shiller national composite house price index increased 7.3 percent for 2012), delinquencies will remain elevated for several more years with employment and wage growth weak and many homes still underwater. Thus, it is important for FHA to work aggressively to avoid claims and reduce the size of those that cannot be avoided. Loss mitigation is especially important in communities with a high

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<sup>16</sup> Ibid.

concentration of delinquent loans because the spillover effects of foreclosures producing further house price declines will hit the Fund doubly hard. FHA has stepped up its loss mitigation efforts. It changed REO disposition processes, revised modification treatment to address better delinquent loans, and has created an alternative resolution process for negative-recovery loans. FHA also has made a major effort to sell defaulted notes to servicers who may be able to avoid foreclosures or get better recoveries, thus reducing losses to the Fund. It also started the Claim Without Conveyance program so that a lender, rather than foreclose and convey a property to FHA in order to submit an insurance claim, can sell the property directly and submit a claim to FHA without FHA ever taking title to the home. These practices allow FHA to take advantage of the superior ability of private servicers to manage REO efficiently and improve recoveries.

- (3) **Adjusting mortgage insurance pricing and increasing revenue:** HUD has raised fees in order to increase revenue and strengthen the economic value of the MMI Fund. Since 2009, it has increased the Mortgage Interest Premium four times. The Actuary estimates these changes produced more than \$10 billion in additional economic value for the Fund.<sup>17</sup> There are limits, of course, to how much premiums can and should be increased to recover costs incurred from earlier books of business. There is an inherent unfairness to making current home purchasers pay too much more because insurance was underpriced in an earlier era. However, at a time of record low interest rates and still-limited competition from the private sector to serve most FHA borrowers, the market can bear higher prices without FHA being adversely selected.

While more can and needs to be done, much progress has already been made in addressing some of the remediable sources of recent losses.

#### 4. **New Tools for FHA to Act Quickly to Manage and Mitigate Risk**

A key pattern emerges from looking at FHA's recent performance. When FHA incurred losses that it might have avoided—that is, those losses which were not fundamental to FHA's countercyclical role or the inevitable consequence of calamitous economic and housing market conditions—the losses stemmed from the slow pace of change at FHA and the ways in which a government agency cannot typically act as quickly as a private company can to protect itself against risk.

Think about the steps taken by the capital market investors to reduce their exposure to mortgages quickly as the market meltdown began. Think about how financial institutions tightened underwriting standards virtually overnight and dropped products that were proving to be expensive as soon as the costs were understood. Officials at a wide range of institutions

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<sup>17</sup> Ibid.

exposed to mortgage credit risk, even at the GSEs, were able to comparatively quickly take steps to stop the bleeding. But not so at FHA.

For example, FHA officials have been asking Congress for legislative changes to reduce losses in key programs since 2010. If some of those provisions had been adopted sooner, some fraction of taxpayer losses would have been avoided. For example, Commissioner Galante testified two weeks ago before that House that, three years later, HUD is still awaiting authority to seek indemnification from direct endorsement lenders and the ability to quickly terminate a lender's ability to originate FHA insured loans.

Similarly, HUD has made far too little progress in implementing changes to the HECM program to better serve its intended purpose because they must complete an extremely slow and cumbersome rulemaking process. In general, in rulemakings about tightening criteria for FHA loan programs, there is little constituency for protecting the taxpayer from losses and enormous energy invested in the status quo from program participants. An eerily similar tale can be told about the seller-funded down payment assistance loan program.

I do not wish to point fingers at Congress. These are extremely technical underwriting, loss mitigation, and pricing decisions that, to my mind, do not lend themselves well to legislative deliberation. Congress should provide a statutory framework, set appropriate goals and tolerance for risk, and provide effective oversight. My proposal would leave these essential legislative functions in Congress' hands.

- **“Risk management emergency powers: emergency authority to suspend issuing insurance under risky terms and conditions.”** I propose a way to respond to this problem, create greater transparency, and ensure opportunity for effective congressional oversight. Congress should give the HUD secretary special emergency powers to suspend FHA insurance programs or make emergency modifications to the program when the secretary finds that continuation under current program terms *exposes the taxpayers to “elevated risk of loss” and “fails to serve the public interest.”* Any such emergency action to terminate insurance would need to be accompanied by analyses of (1) the potential cost savings to the FHA Fund and the taxpayer risk that would be avoided; and (2) whether the program objectives established by Congress would be furthered or harmed by temporarily suspending insurance until program terms and conditions can be altered. The emergency authority proposed here would be time limited, requiring the HUD secretary to complete all appropriate administrative procedures to make the change permanent (or seek congressional authorization if a statutory mandate was involved). Congress could at any time vote to disapprove the use of the emergency powers by the secretary if they felt the risk was not properly assessed or the change was not necessary to meet public ends.

FHA has also faced difficulty in establishing early-warning risk indicators and in taking steps quickly to stop specific originators from continuing to add loans to FHA's insurance portfolio which are markedly more likely than others to end in default. Commissioner Galante testified two weeks ago that HUD sought changes to the "statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance." Specifically, the secretary seeks to compare early defaults and claims by a range of factors including geography, underwriting, or populations served.

To my mind, the HUD secretary's request of Congress is too timid. It is in the public interest to empower the HUD secretary, who is overseeing a trillion dollars of taxpayer risk exposure, to use any early-warning indicator that evidence suggests is predictive of losses, provided that its use does not discriminate or otherwise violate the law. When HUD officials know that taxpayers are being exposed to undue risk, it shocks the conscience to say that they must continue to accept such loans for insurance pending administrative procedures and overcoming burdens of proof. We should want FHA staff to be able to continuously refine its early warning indicators, be transparent about the risks that it is seeing, and take steps quickly to adopt new tools as they become available.

I do understand that the implementation of the FHA Compare Ratio, like any other early-warning indicator, will potentially have unintended consequences that do not serve the public's interest. But it seems to me appropriate to shift the burden of proof, so that it is easier to protect taxpayers against risk and harder to continue to originate questionable loans for the FHA insurance portfolio.

- **Early-warning risk indicators.** Congress should give the HUD secretary the authority to establish appropriate risk indicators on an ongoing basis and to use these indicators to limit access to participation in FHA insurance programs where these indicators suggest a lender, servicer, or other program participant is more likely to expose the taxpayers to risk. When program participants can overcome a burden of proof that they do not pose undue risk or that a better indicator is available, then FHA's decisions can be subject to scrutiny. But the goal should be to give the taxpayers—not program participants—the benefit of the doubt.

Another concern is that FHA tends to adopt new programs or program changes for its entire portfolio. There are exceptions, of course. FHA did begin to pilot note sales before expanding the program. But too often, unlike private-market participants that will try out a new business practice or insure a small portfolio and test performance before applying a strategy to the whole business, the statutory and regulatory environment for FHA leads to "all or nothing" policy changes. The length of the administrative procedures required also leads to full implementation rather than testing, because an evolutionary or phased change strategy would require iterative regulatory changes and sap so much administrative energy. These practices inherently increase

risks to the Fund because new policies go into effect without enough evidence of their likely impact.

- **Risk reduction pilots—authority to pilot new policies to test their costs and benefits before implementation.** Congress should give FHA express authority to implement pilot programs quickly where the goal is to better understand, measure, and mitigate risk. Full implementation would follow normal administrative procedures. So, for example, FHA could test whether a new alternative underwriting standard (e.g., incentives for pre-purchase counseling), or loss mitigation procedures, or REO disposition approach can achieve program objectives in a cost-effective manner.

Finally, an ongoing concern is whether FHA has the systems, technology, and analytical prowess to reengineer business practices to reduce risk, to understand emerging risks in their portfolio before it is too late, and so on. Giving the HUD secretary authority to hire for risk management, analytic, and technological systems staff on a more generous pay scale could close some of the gap between private-market participants and those charged with protecting the taxpayer from economic harm. Bank regulators are compensated slightly better than other government officials so that the agencies can attract the talent with financial knowledge and analytic skills for effective financial regulation. And regulators can use funds assessed on those they regulate to support the operations, systems, and other needs of the agency to protect taxpayers from losses from insured depository institutions.

- **Allow FHA to hire for select positions at elevated compensation levels to ensure that FHA can attract appropriate insurance, financial, and risk management skills. Also provide FHA with the ability to use insurance premiums for systems and analytical model acquisition to strengthen their capacity to mitigate risk.**

## 5. Summary

Mr. Chairman, Senator Crapo, and members of the Committee, it is clear that the health of FHA's MMI Fund has suffered because of losses resulting in part from problematic products and processes. Of course, rapidly falling house values due to a persistent economic recession and deep foreclosure crisis were the driving factor. Many of these losses were inevitable—and many result from FHA's critical role of ensuring credit flow and availability, which is particularly relevant during recessionary periods. However, it is also clear that better analytic capacity and management tools and the capacity to move more quickly to protect the taxpayer from losses could improve FHA's ability to manage, price, and mitigate risk and to, ultimately, protect the Fund.

FHA has taken important steps to stem losses where avoidable in outstanding books of business and to prevent insuring higher-risk loans going forward. They seek additional important

authorities that would further strengthen the Fund. But those steps, to my mind, do not seem to fundamentally change the capacity of FHA to act quickly in the taxpayer's interest. Clear goals established by Congress, greater data transparency, and more authority to respond rapidly to changing conditions and new insights, to manage and mitigate risk, would go a long way to strengthening the Fund going forward and ensure that FHA does not again become so perilously close to requiring taxpayer support.

FHA's place in the housing finance system in the long term will depend upon how policymakers resolve questions about the shape of the housing finance market and whether a limited, priced and paid for government guarantee of high-quality mortgage-backed securities is available in a reformed system, after the demise of Fannie Mae and Freddie Mac in their current form. We must not take steps now, absent those larger discussions, that would make it impossible for FHA to continue to play its indispensable countercyclical role and its ever-important mission of ensuring credit is available to worthy borrowers who have limited options in the private market. But we can seize this opportunity to strengthen FHA's risk management capacities immediately. For whatever role is assigned to FHA in the long term, we all will be better served if they have the capacity to manage better the risk they take on in fulfilling that mission.

Thank you.