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“Reform of FHA’s Title I Manufactured Housing Loan Program”

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Thank you, Chairman Allard, Ranking Member Reed, and distinguished members of the Subcommittee. My name is Michael Frenz and I am the Executive Vice President and Chief Operating Officer of the Government National Mortgage Association (Ginnie Mae). I have held this position since October 2004.

I appreciate having the opportunity to testify before you on S. 2123, the FHA Manufactured Housing Loan Modernization Act of 2005.

Section 2 of this bill (“Findings and Purposes”) states, “The dramatic reduction in the use of the Title I program is due primarily to certain structural problems of the program, which have resulted in refusal by Ginnie Mae to accept new participants into the program....” It is my intention today to provide a thorough description of the structural features of the current Title I program that exposed Ginnie Mae to significant risks, and ultimately led to Ginnie Mae’s decision to curtail its exposure to these risks by imposing a moratorium on the approval of new issuers of securities backed by Title I loans.

Ginnie Mae’s Mission

Ginnie Mae’s mission is to support affordable housing by linking local housing markets to global capital markets. We do this by guaranteeing mortgage-backed securities (MBS). Ginnie Mae securities carry the full faith and credit guarantee of the United States Government. Ginnie Mae has securitized more than \$2.4 trillion in MBS, helping more than 32 million low- and moderate-income families become homeowners. Additionally, we meet our mission without directly buying, selling, or issuing securities. Instead, we guarantee MBS issued by private financial institutions. The Ginnie Mae full faith and credit guarantee assures investors they will receive timely payments of principal and interest on their securities.

A clear understanding of the nature of the Ginnie Mae guarantee – that is, that Ginnie Mae insures investor payments, not borrower mortgages – and the manner in which its business model limits exposure to credit risk is crucial to understanding the challenges we have encountered in our manufactured housing securitization program.

Ginnie Mae’s securities are comprised of loans backed by single-family, multifamily, and manufactured housing units. These loans are individually insured or guaranteed by the federal agencies with which Ginnie Mae partners – in the case of manufactured housing, FHA.

The Ginnie Mae guarantee is activated only when the financial institution that issued the security fails to meet its obligation to make security payments to the investor. Because the loans are individually insured, this generally happens only when an institution fails.

The existence of loan-level insurance coverage provided by other federal agencies typically means that Ginnie Mae assumes minimal credit risk. When an issuer fails, Ginnie Mae steps in, assumes responsibility for the portfolio, and becomes subject to the same risks as the issuer, where losses are influenced by borrower credit risk, the value of

the underlying collateral, and the time it takes to dispose of that collateral. As a result, like any other issuer, Ginnie Mae's risk exposure is largely dependent on the nature of the insurance or guarantee provided at the loan level.

Ginnie Mae began securitizing manufactured housing loans in the early 1970s. At the peak of the manufactured housing program, Ginnie Mae guaranteed approximately \$3 billion worth of securities, and had about 30 to 40 active issuers. Between 1986 and 1988, however, 12 Ginnie Mae issuers with \$1.8 billion of securities backed by Title I loans defaulted, resulting in Ginnie Mae assuming their portfolios and suffering significant losses.

One of the actions Ginnie Mae took to mitigate this risk was to impose a moratorium on the acceptance of new issuers into the manufactured housing program in 1989. This moratorium helped limit Ginnie Mae's subsequent losses; since 1989 only 10 more issuers with about \$500 million of securities defaulted. To date, Ginnie Mae has experienced \$514 million of losses on these defaulted portfolios.

Title I Structural Features

Why were Ginnie Mae's losses on these portfolios so severe? A number of structural features unique to the Title I program exposed Ginnie Mae to risks that, for all intents and purposes, could not be mitigated. These features include:

- The existence of limits on the amount of FHA insurance per lender;
- The existence of co-insurance between FHA and the lender;
- The underwriting process for Title I loans; and
- The calculation for the payment of claims by FHA.

While each of these features serves to mitigate FHA risks, the collective impact exposed Ginnie Mae to significant risk, rendering its losses more severe and less predictable. I would now like to take the time to discuss each of these features in greater detail.

First, Title I requires FHA to limit its loss exposure by capping lender insurance coverage at 10 percent of all originations and purchases. After FHA pays the lender claims in an amount equal to the 10 percent cap, it will pay no additional claims. In other words, insurance is not provided on a per loan basis, but rather is limited to a defined percentage of each lender's portfolio. Tying the maximum amount of insurance coverage available to lenders to the volume of loans originated, created a classic moral hazard problem: as lenders' portfolios experienced losses, they were incented to make more loans in order to increase the amount of claims payments for which they were eligible. And, when the claim limits were reached on troubled portfolios, lenders had little incentive to continue servicing portfolios and were more likely to stop making payments to security holders. Thus, Ginnie Mae sustained substantial losses when it assumed the portfolios of these lenders who had already exhausted their FHA insurance coverage.

Second, Title I is a co-insurance program: at the loan level, FHA reimburses a lender for 90 percent of the loss, and the lender takes the remaining 10 percent of the

loss. While co-insurance can decrease the incentive for lenders to make risky loans, it had the opposite effect when combined with the portfolio cap; co-insurance caused lenders to reach their caps, which in turn resulted in significant losses for Ginnie Mae.

Third, Title I loans are registered for insurance, but are not endorsed. This means that, unlike for Title II loans, FHA does not review Title I loan eligibility for insurance coverage at origination. Instead, FHA reserves the right to contest the payment of a claim on a manufactured housing loan for up to two years after it has already paid the claim. Therefore, a lender has no assurance that a loan in its portfolio will be eligible for insurance and a claim will be paid. This differs from Title II single-family loans, where the insurance contract is deemed to be incontestable upon endorsement of the loan. While this is a prudent practice for FHA, to the extent that Ginnie Mae takes a defaulted portfolio, this feature exposes Ginnie Mae to potentially higher losses.

Finally, the Title I formula for calculating FHA's payment of claims limits the amount of the claim to the outstanding principal balance of the loan less the appraised value of the manufactured housing unit. Often the market value of the manufactured home is less than the appraised value. If the sales price of the manufactured housing unit falls short of the appraised value, the difference is the lender's responsibility. This provision limits FHA's exposure, but increases losses suffered by the lender – and by Ginnie Mae in the event of an issuer default.

Taken together, these four structural features of the Title I program contributed to the significant losses experienced by Ginnie Mae. Today, the manufactured housing program has been almost completely wound down.

There are now only four approved issuers in the Ginnie Mae manufactured housing program, with just one currently active. In 2005, only \$9 million in new securities were issued, and the total amount of securities has steadily decreased to the point that, as of the end of 2005, there were only approximately \$187 million outstanding. In addition, the total remaining balance of the manufactured housing portfolios that Ginnie Mae assumed due to issuer defaults has decreased to \$53 million, of which \$25 million is in the form of Ginnie Mae securities, and \$28 million is in loans and repossessed manufactured housing units.

Conclusion

In summary, the structural features that I have discussed today made it impossible for Ginnie Mae to maintain a viable manufactured housing securitization program. To the extent that the Title I program is restructured, Ginnie Mae would consider lifting its current moratorium on the program and work with FHA to support this important product that helps many Americans achieve their dream of homeownership.

Thank you for this opportunity to discuss Ginnie Mae's experience with its manufactured housing securitization program, and I would be pleased to answer any questions you may have.