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U.S. Department of Housing and Urban Development

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“The Role of the Federal Housing Administration (FHA) in Addressing
the Housing Crisis”

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Chairwoman Murray, Ranking Member Bond, and members of the Subcommittee, thank you for the opportunity to speak with you today about the state of the Federal Housing Administration (FHA).

I come before you in a historically unique moment. Our economy has deep challenges: unemployment is high, incomes are falling, and home foreclosures are greater than at any time since the Great Depression. The Obama Administration has responded with a comprehensive and multifaceted program to stimulate our economy and revive our housing markets: a recovery package to create or preserve 3-4 million jobs, a comprehensive program to stabilize financial markets, lower mortgage interest rates and unfreeze credit markets; and new efforts to help homeowners refinance their mortgages, avert foreclosures, stabilize hard hit neighborhoods and end the downward pressure on housing prices.

HUD has a critical role to play in each of these areas. I am deeply appreciative of your committee for providing HUD with \$13 billion in recovery funds, including a new infusion of funding for the Neighborhood Stabilization Program to help communities prevent blight and make foreclosed homes community assets rather than liabilities. HUD has been deeply involved in the development of the Obama Administration's Homeowner Affordability and Stability Plan (HASp), including the Making Home Affordable initiative that will allow 4 to 5 million homeowners now locked out of GSE refinance options to take advantage of today's lower rates, and help 3 to 4 million additional borrowers receive affordable, sustainable loan modifications and avert more costly foreclosures.

But no part of HUD is more central and important to our national effort to promote affordable homeownership than the Federal Housing Administration, and I am committed to making FHA as responsive to market demands as it was when it was founded.

FHA Past and Present

As you all well know, the FHA was created in 1934 to address a set of economic conditions that were unquestionably of greater scale, but clearly of similar character to what we are facing today. Property values were declining. Unemployment was rising and incomes were dropping. Families could not pay their bills. It is no surprise that many homeowners could not meet their mortgage obligations. The overall contraction in the credit markets meant that borrowers had no place to turn to refinance out of their mortgages, which, at that point in history, were most often structured with five-year terms and "balloon" repayment schedules.

FHA was set up as a government mortgage insurance company to protect financial institutions from risk of loss and, in so doing, to encourage lenders to make longer-term, fixed rate home loans. The goal was to create liquidity and stability for the mortgage and real estate markets – to provide families access to credit, to keep them in their homes, and to offer homebuyers a new way to buy homes, by offering longer-term affordable financing.

The agency's mission has not changed since that time. As part of this mission, FHA continues to play a *countercyclical* role – serving as a backstop to the private mortgage market. FHA stays active in volatile and declining markets, continuing to make mortgage credit available to borrowers, even when private mortgage providers are withdrawing from the market. During difficult times, it is critically important to have an entity like FHA play this role – offering families access to near-prime rate financing. FHA picked up private market slack in Texas, Oklahoma and Louisiana during the Oil Patch bust in the late 1980s and in Southern California during the early 1990s, and it is playing this role again today.

Current market conditions highlight the critical role of the federal government in keeping mortgage credit flowing. With the collapse of global credit markets, FHA, Fannie Mae and Freddie Mac must continue to work with strong and well managed private sector entities to expand access to mortgage credit in the market. In particular, FHA's role has grown substantially from 3 percent of lending activity by dollar volume in 2006 to approximately 30 percent of all mortgages originated today.

FHA's Challenges

FHA is now playing a critical role in addressing the current mortgage crisis, but FHA also faces many challenges today. Like many federal domestic agencies, FHA has suffered under the penny-wise and pound foolish priorities of the previous administration. FHA was stagnant, limiting its ability to maintain adequate staffing levels and invest in state-of-the art technology. Repeated budget stalemates and resulting uncertainty of future funding levels undermined the ability to implement long-term organizational improvements.

While FHA's volume of business has increased dramatically in the last two years and increased administrative appropriations will help ensure FHA properly oversees this workload. We certainly are appreciative of the additional funding and management flexibility we received in the FY 2009 appropriations process and plan to bolster our staffing quickly. Outdated information technology (IT) systems, systems that were built to handle simpler and smaller mortgage programs, continue to serve as the primary vehicles for collecting, tracking, and validating program data and performance.

At the same time, I know that you Senator Murray and the rest of the members of this Committee share my concerns of the importance of helping FHA continue to operate safely and soundly in the current environment. Your actions in the FY09 budget to allow FHA to have greater staffing and flexibility across the departments of the agency was a critical first step in helping to build a stronger and more market savvy FHA. But it was just a first step. For FHA to realize its full potential to respond to the current mortgage crisis it will require additional resources and development of new and innovative reform initiatives.

That is why I was so pleased last week when President Obama announced his intention to nominate David Stevens to be the Assistant Secretary for Housing/Federal Housing Commissioner. I believe that Mr. Stevens is one of the best and brightest in the mortgage

business with experience ranging from mortgage originations, to secondary markets, to managing a national real estate firm. Should he be confirmed by this body, Mr. Stevens and I will work closely together to diagnose and address the challenges now facing FHA. Mr. Stevens brings a hands-on systems approach to mortgage origination, and is anxious to see first-hand the status of FHA's systems and programs and to quickly put in place process and technology improvements in all facets of FHA's operations

FHA Performance Today

Prior to a fuller review, it is already clear to me that the agency has done good work in meeting the growing needs of the industry and the public. With resources constrained, the leadership and career staff at FHA have worked hard to process rapidly growing levels of new business, upgrade business processes and bring new FHA products – like FHA Secure and Hope for Homeowners -- to market in record time.

But we all know that the FHA team cannot sustain their efforts and protect the programs over the long-term without an infusion of resources: for new staffing with new skills, investments in new state-of-the art technologies, and new efforts to reach out to enforcement agencies at all levels of government to better monitor FHA partners. In addition, the organization must continually rethink how to best reshape its product mix and pricing, particularly in light of today's dramatic market changes. The organization needs all of us to commit to providing the support needed to implement strategic improvements in its business operations and program designs.

As is the case with other mortgage market participants, currently FHA is experiencing elevated defaults and foreclosures and with it, losses that exceed prior estimates. In contrast to the subprime sector, where unsafe loan features and poor underwriting made those mortgages risky from the start, for FHA, the primary reason for defaults and foreclosures continues to be loss of income combined with low or negative home equity, and economic factors present in today's environment. Although this is a challenging time for all entities in the mortgage market, FHA is unlikely to face the catastrophic losses borne in the subprime sector. FHA loans continue to substantially outperform subprime loans: only 7 percent of FHA loans are seriously delinquent (greater than 90 days delinquent or in foreclosure) compared to more than 23 percent of subprime loans.

Moreover, much of our recent loss activities have been attributable to the growth in *seller-funded* down payment assistance. These loans grew from under 2 percent of all FHA home purchase originations in FY 2000 to greater than one-third of purchase originations in FY 2007 and 2008. The seller-funded down payment originations result in completed foreclosure at three times the rate of loans where borrowers provided their own downpayments and while they only represented 12 percent of the FHA portfolio at the start of 2008, accounted for 30 percent of all foreclosure completions that year. The termination of this program should substantially reduce FHA losses on new originations in the years ahead.

Several factors should mitigate the damage that the current deep recession wreaks on FHA's portfolio. First, before mid-2008, FHA's constrained loan limits reduced its market share and hence its exposure in some of the nation's highest-cost housing

markets, including California, where price declines and related foreclosure activity have been particularly intense.

Second, FHA has been attracting better quality borrowers in the last year. With much tighter underwriting standards in the private market, more higher quality borrowers can't qualify for conventional financing and end up with FHA-insured loans. Credit scores for new borrowers grew sharply in 2008, averaging over 680 at the end of 2008, compared to prior year averages of around 640. This is a positive development although, given the dynamic housing market, it is difficult to say how long this trend will continue in the future.

FHA is now playing its traditional role in today's turbulent market. But it's important to understand the positive trends as well. My goal is to continue my efforts to identify both the existing strengths and weakness of FHA, to work with Congress and the rest of the Administration to make sure that FHA has the right healthy program mix and pricing structure, is actuarially sound, and the organizational capacity to continue to expand homeownership opportunities to those families traditionally not well served by the private market place.

Enhancing FHA Operations

Since FHA insurance is backed by the full faith and credit of the United States government, I want to assure the market participants that FHA insurance is as reliable as ever and there is no possibility of FHA "running out of money." Under authority provided to all federal loan programs, FHA has indefinite resources to honor its outstanding commitments. At the same time, I want to reiterate my concern that FHA *does* need to make significant business process improvements to cope with growing demand and secure state-of-the-art fraud detection and risk management systems.

Expanding Use of Automated Risk Management Tools

It appears to me that FHA relies too heavily on manual processes and needs to adopt more automated processes for underwriting and risk management. Today, approximately 90 percent of FHA's 850 Office of Single Family staff and 100 percent of its contract dollars are devoted to risk management practices. They perform three types of risk management duties: assessing and monitoring business participants in FHA business, including lenders and appraisers; evaluating individual loan files to ensure compliance with FHA underwriting standards; and monitoring the entire insurance portfolio, by analyzing performance trends. The concentration of so many resources on quality control means that simply freeing up staff from other functions to provide additional support is not an option; there are very few staff who do anything but quality control.

Underwriting: Working in partnership with the GSEs, FHA developed and utilizes an automated underwriting engine, but has not been able to keep it updated for analytic, market and technological changes. This is an area I'll look to improve. Greater reliance and application of automated underwriting systems would also enhance uniformity in the application of policy changes, which are now subject to interpretation by four FHA

Homeownership Centers (HOCs). Getting organizational standards aligned with centralized oversight is critical, as is the need to continuously enhance the training of existing staff in FHA's own rules and procedures.

Fraud Detection: Technology can also enhance FHA's fraud detection by borrowers. Automated risk management tools are being used industry-wide with great success, offering an efficient and effective means to access a large amount of critical information that can be used to detect the most common types of mortgage fraud – falsification of borrower identity, income, and employment and misrepresentation of property value.

Better automated tools will expand FHA's ability to closely monitor past and present practices of FHA-approved lenders and appraisers. Specifically, the best industry tools tap into public data sources that provide FHA with information that is not readily apparent in individual loan files or in the FHA-specific activities of lenders and appraisers. Access to this broader mortgage-related data set will help FHA uncover problematic practices before FHA insures loans or grants approval to lenders and appraisers to participate in FHA program.

To that end, we have already secured the use of anti-fraud technology for our HOPE for Homeowners program and are now looking to expand the use of that tool to all of FHA's single family business. Unfortunately, by statute, the HOPE for Homeowners funding cannot be used to support the core FHA refinance and purchase programs. Thanks to our FY 2009 appropriation, we now have funding and an existing contract to begin testing the use of the fraud detection tool on the entire FHA single family portfolio. The pilot will serve as the basis of the framework for full implementation of the tool in fiscal year 2010.

These efforts tie in directly to the Obama Administration's multi-agency "Combating Mortgage Fraud Initiative." Under this initiative, HUD and FHA will be playing a central role, and the Department has requested additional 2010 resources specifically for investing in additional systems to enhance fraud detection and monitor lender originations. This initiative will also include additional resources for the FBI and the Justice Department to investigate and prosecute mortgage fraud.

Finally, as you well know, FHA's basic program data and technology systems are old and woefully inadequate. The basic IT infrastructure – both hardware and software – is outdated and inflexible. The various data systems are not well-integrated, so time is wasted reconciling data across systems that all collect the same information individually. Finally, and of greatest concern, the systems were written to support business procedures that have changed substantially and the tools themselves force FHA to maintain some practices that no longer make sense. To that end, we will be requesting funding in our FY 2010 Budget for IT investments and prioritize the modernization of FHA IT systems to upgrade our technology, to replace obsolete systems, and to invest in infrastructure that can support our core systems into the future.

Investing in Human Resources

Automated tools to assist in risk management will be a good addition, but FHA also needs more staff and staff with a different skills mix than our current workforce. We need to bolster specific expertise and skill sets: housing finance, including underwriting and appraisals; quality control and risk management; and policy analysis and communications. Recent hirings have brought some new skills, but with one of the oldest workforces of all federal agencies, retirements continue to take their toll.

Therefore, I want to thank you, Chairwoman Murray and members of the Subcommittee for providing an additional \$12.7 million in funding specifically for the Office of Housing to hire approximately 200 additional personnel. The agency has already developed a staffing plan and job announcements are underway.

Priorities Going Forward

As noted earlier, my top priority for FHA is shoring up the basic infrastructure of the program to ensure that it continues to meet the needs of underserved borrowers through this current mortgage crisis.

Helping Borrowers Avoid Foreclosure: Last month, President Obama announced a bold plan to help borrowers avoid foreclosure. In addition to the Making Home Affordable components that I mentioned earlier, the President has called on Congress to enact carefully crafted bankruptcy reform, along with important reforms to enable FHA to play a larger role in the overall effort to stabilize our nation's housing market. As you know, housing legislation (HR. 1106) has passed the House and is now before the Senate. We hope it gets enacted quickly, so that more borrowers can avert foreclosures

I would like to direct your attention to two critical elements of that package: proposed changes to Hope for Homeowners and reform of FHA's loan modification tools.

While Congress and the Administration had high hopes for the Hope for Homeowners program when originally enacted last year, it has refinanced very few borrowers. I still believe in the original premise of Hope for Homeowners: that many investors would be willing to accept a refinance for less than the full amount of their loan to avoid the uncertain possibility of future defaults. It could fill an existing program void to refinance underwater borrowers who do not qualify for either the Making Home Affordable refinance or loan modification programs is a necessary addition to a comprehensive array of foreclosure prevention tools.

We look forward to working with you and other leaders in the Senate and House to develop a set of Hope for Homeowners programmatic reforms that will provide HUD greater flexibility to better meet this critical need in the marketplace.

In addition, I urge the Senate to enact pending provisions to enhance FHA's loss mitigation program. Specifically, we are anxious to incorporate new legislative authorities to enhance FHA's use of partial claims to help facilitate more aggressive and

timelier modifications in FHA insured loans that are in imminent danger of default. These changes will more closely align the FHA loan modification program with the Making Home Affordable modification program in conventional market. More importantly, these reforms hold the promise of reducing losses to the FHA fund by intervening at the earliest sign of mortgage payment difficulties

Creating New and Innovative Products: FHA can also be a market leader in developing and introducing new mortgage products to make it easier and less expensive for homebuyers to finance energy improvements. Energy improvements reduce long-term costs to homeownership in the form of lower utility bills. In addition to making Energy Efficient Mortgages (EEMs) easier to obtain for homebuyers, we can work with Fannie Mae and Freddie Mac to coordinate product designs so that they are easily understandable and accessible to lenders and borrowers.

Getting to scale in energy efficient mortgage development will require the creation, testing and potential adoption of a range of approaches. The objectives for these programs include creating the proper incentives for energy-efficiency, being “user-friendly” to both borrowers and lenders, and exhibiting a sound cost and risk profile compared to other energy investments. Those approaches include streamlining HUD’s existing, but under-utilized energy efficient mortgage program, and allowing greater flexibility in use of the EEM. The program would extend the benefits of the existing FHA Energy Efficient Mortgage (EEM) program to more homeowners through a coordinated approach that addresses supply-side, demand-side, and financing issues, while providing a mechanism for evaluating strengths and weaknesses of the initiative.

Rethinking FHA’s Role in the 21st Century Mortgage Market: The recent mortgage market meltdown has provided ample evidence that we must work to rethink each and every aspect of the nation’s housing finance system. Building on its historic mission, I am committed to insuring that FHA continues to provide liquidity and stability to the mortgage market, while at the same time developing the new products and programs that continue to expand access to homeownership to lower-income and lower-wealth households not well served by the private market. This is not to say that all households should become homeowners – we still need to provide decent and affordable rental housing to those who by choice or necessity remain as renters. But FHA has led the market in the past, and I am committed to making FHA once again a market leader.

Conclusion

In summary, I want to assure the Committee that while significant challenges exist, the FHA is prepared to meet these challenges head on. I’m looking forward to having David Stevens confirmed and take the reins at FHA.

Together we are committed to an ambitious reform agenda:

- modernizing FHA’s core technology systems;
- enhancing our business practices;

- ferreting out fraud among borrowers and lenders;
- fixing and scaling up the Hope for Homeowners refinance program for “underwater” borrowers;
- revamping FHA loan modification efforts to reduce foreclosures;
- stimulating new energy efficiency mortgage products into the market, and
- restoring FHA to a respected position of leadership in the marketplace.

I want to thank you for having me here and I’d be happy to answer any questions.