SPENCER BACHUS, AL, CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

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Memorandum

To: Members, Committee on Financial Services

From: Committee Staff

Subject: Financial Services Full Committee Hearing on "Perspectives on the Health of the FHA Single-family Insurance Fund"

On Thursday, December 1, 2011, at 10:00 a.m. in Room 2128 of the Rayburn House Office Building, the Financial Services Committee will hold a hearing on "Perspectives on the Health of the FHA Single-family Insurance Fund." The hearing will examine the financial status of Federal Housing Administration (FHA) and the actuarial review of the FHA's Mutual Mortgage Insurance Fund (MMIF) for Fiscal Year 2011, released by the Department of Housing and Urban Development (HUD) on November 15, 2011.

The Role of the Federal Housing Administration

The National Housing Act of 1934 established the FHA as a division of HUD. The FHA's mission is to provide federal mortgage insurance in order to broaden homeownership, protect lending institutions, and stimulate the building industry. Before the FHA was established, home mortgages did not exceed 50 percent of home values and were short term, lasting no longer than five years. At the end of the fifth year, homeowners had to pay their mortgages in full or roll them over. During the Great Depression, lenders were unable or unwilling to roll over loans that came due. As a result, many borrowers lost their homes and lenders lost money because property values declined significantly.

The FHA was established to provide stability and liquidity in the market. Its creation fostered the 30-year mortgage and led to standardized mortgages. The FHA is intended to be self-funded: premiums paid by homeowners for FHA mortgage insurance are used to pay for the costs of running the program and cover losses when loans default.

During the housing boom of the mid-2000s, the FHA's share of the mortgage market fell to under two percent of mortgage originations (measured by dollar volume) at the end of 2006. As housing prices began to decline, lenders tightened their underwriting criteria and the FHA began playing a larger role in the mortgage market. The Congressional Research Service has reported that during FY2010, the FHA guaranteed nearly 40 percent of home-purchase mortgages originated or refinanced, which corresponds to approximately 1.1 million homebuyers. FY 2010 was the second time that the FHA has assisted more than 1 million homebuyers in a single year. According to the FHA, the federal mortgage insurance

program currently insures more than $1 trillion worth of mortgages on more than 7 million loans.

In recent years, more homebuyers have turned to FHA-insured loans to take advantage of lower down-payment requirements for FHA loans, which are currently 3.5 percent of the property's appraised value. Larger down payments make it more difficult for first-time and low-income homebuyers to purchase houses; thus, when banks and private mortgage insurance companies tightened their underwriting criteria and required down payments greater than 3.5 percent, many borrowers turned to FHA-insured mortgages as an alternative.[1]

FHA's FY 2011 Actuarial Report and Health of Single-Family Insurance Fund

At the same time that FHA's market share has been growing, the FHA—like most other participants in the mortgage market—has been faced with higher default rates. FHA thus finds itself supporting the mortgage market by insuring new home loans as it seeks to shore up the stability of its single-family insurance fund, the Mutual Mortgage Insurance Fund. The MMIF's capital reserve ratio, which is one measure of the MMIF's strength, fell to 0.50 percent in FY2010. By statute, the FHA is required to maintain the MMIF's capital reserve ratio at 2 percent.[2]

HUD released the FHA's FY 2011 Actuarial Report, prepared for HUD by an independent auditor, on November 15, 2011. The Actuarial Report showed further deterioration of the MMIF's capital reserve ratio, which fell to 0.24 percent in FY 2011. The FY 2011 Actuarial Report also noted that the MMIF's economic value—which is the MMIF's existing capital resources plus the net present value of FHA's current book of business—as of the end of FY 2011 was $1.19 billion, a decrease of 77 percent from the MMIF's $5.16 billion economic value as of the end of FY 2010. The fall in the MMIF's economic value resulted from further declines in national home prices of more than five percent, more loans having elevated default potential, and uncertain economic conditions. The FY 2011 Actuarial Report concluded that under more pessimistic economic scenarios than the Report's base-case assumptions, the MMIF's economic value may be negative in FY 2011 and remain negative until FY 2018.

As a result of the MMIF's falling capital reserves, the FHA is vulnerable to further defaults. Because FHA guarantees are backed by the federal government, a large number of defaults could result in significant losses to the FHA that would ultimately by borne by taxpayers. If the MMIF were exhausted and FHA lacked funds needed to pay insurance claims, the U.S. Treasury would have to cover lenders' claims directly. To improve the program's finances, the FHA has made several changes to strengthen its single-family program. The FHA has created a Chief Risk Officer position, modified documentation requirements for refinancings, adjusted underwriting standards, and bolstered its enforcement tools.

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[1] Darryl E. Getter, "Federal Housing Administration (FHA) and Risky Lending," CRS Report for Congress R40937, June 10, 2010, *available at* http://www.crs.gov/Products//r/pdf/R40937.pdf.

[2] The capital ratio measures the amount of capital that FHA has on hand as a percentage of its insurance obligations, above and beyond the amount of capital set aside to cover expected losses on its current mortgage portfolio.

On August 12, 2010, the President signed Public Law 111-229 into law, which grants HUD the authority to increase the premiums that FHA charges for mortgage insurance. In September 2010, HUD announced that it would raise annual premiums to .9 percent and lower the upfront premium from 2.25 to 1 percent. HUD announced that these changes will better position the FHA to meet increased demand and restore the MMIF's capital reserves to congressionally mandated levels, without disrupting the housing market. The new premium levels took effect for FHA-insured mortgages originated after October 4, 2010. In February 2011, FHA again raised annual premiums, to 1.15 percent.

To stabilize the mortgage market and reduce taxpayer exposure to defaults, government and some private-sector entities believe that the private sector must assume a greater role in the housing finance system. In its February 2011 white paper "Reforming America's Housing Finance Market: A Report to Congress," the Obama Administration announced that it intended to develop policies that would make private markets the "primary source of mortgage credit" and bear the burden of losses.