U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410

Written Testimony of Secretary Shaun Donovan
Hearing before the Senate Banking Committee
Status of FHA Programs and the FY 2012 Annual Review of the Mutual Mortgage Insurance Fund

Thursday, December 6, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today regarding the status of the Federal Housing Administration's mortgage insurance programs. The testimony will cover the single family programs, for which we recently submitted a report on the Mutual Mortgage Insurance Fund (MMIF), as well as the multifamily and healthcare programs.

I appear before you today at an important point in the recovery of the nation's housing markets. As 2012 draws to a close, a number of promising signs indicate that our economy is improving and that the recovery of the housing market is underway. The number of families falling into foreclosure is half what it was in the early days of 2009. Housing construction is growing faster than at any time since 2008, and this has been the strongest year of home sales since the crisis began. Finally, rising home values have lifted 1.3 million families above water in the first half of 2012. All of these indicators point to a housing sector on the mend –a sector vital to the broader recovery of our economy.

However, while there is cause for optimism, we must remain mindful that the recovery remains fragile, and that a broad array of factors could limit the progress we are now seeing. Therefore, we must remain diligent in our efforts to restore our housing markets, help families get back on their feet, and enter into a new era of housing finance in this country.

I. <u>Overview of Findings of the Independent Actuary with Regard to FHA's Single Family Programs</u>

It is with this context in mind that I now want to turn to a discussion of FHA's single family programs. Much of the progress that we are seeing in the housing sector has been possible because of the FHA, which has provided access to homeownership for millions of American families and without which the crisis would have been much deeper. In fact, Moody's analytics estimates that were it not for FHA's presence during the crisis, house prices would have fallen 25 percent further than they did already.

FHA's contribution has not been without stress, however. On November 16, 2012, HUD delivered its fiscal year (FY) 2012 Report to Congress on the Financial Status of the FHA Mutual Mortgage Insurance Fund, which is used for FHA's single family programs. That report summarizes the results of the independent actuarial review conducted by Integrated Financial Engineering (IFE) and provides a status report on the fiscal health of the MMI Fund. Via its review, the actuary measures the economic net worth of FHA's portfolio – essentially, the total value of the portfolio after FHA pays all expected claims for the next thirty years in a run off scenario where no new loans are insured. This economic value is then divided by the total value of the MMI Fund's insurance in force to derive an estimated capital reserve ratio for the Fund. According to the latest findings of the independent actuary, in fiscal year 2012 the capital reserve ratio of the Fund fell below zero to negative 1.44 percent, and the Fund's economic value stands at negative $16.3 billion. Earlier books of business continue to be the prime source of stress to the Fund, with fully $70 billion in claims attributable to the 2007-2009 books of business alone. In contrast, the actuary attests once again to the high quality and profitability of books insured since 2010. Thus, this year's report shows that even though our books of business insured since 2010 are the strongest in agency history, there is still work to be done in mitigating the impacts to the Fund of losses stemming from older books of business which were most severely impacted by the recession and other risk factors, such as seller-funded downpayment policies. Toward this end, a series of aggressive measures FHA will take in this fiscal year is discussed later in this testimony.

While the actuary's finding regarding the economic net worth of FHA's portfolio is obviously of very serious concern, it is not the determining factor for whether FHA will need to draw on permanent and indefinite budget authority from the Treasury. Any determination that such a draw is necessary will not be made until the end of FY 2013, and in any event, does not affect the full faith and credit of the Federal Government to pay any claims. In the intervening period, the President's budget will outline the Administration's expectation of whether or not FHA will need assistance by the end of the fiscal year. However, the ultimate need will be borne out in the actual performance of the FHA single family program over the course of the fiscal year, and will be impacted by the steps FHA takes over the course of the year to increase revenue or reduce losses.

While the magnitude of the figures involved in this year's budget re-estimate are large, as an example, the President's FY 2013 budget submission, issued in February of this year, anticipated that FHA would need to draw nearly $700 million in assistance from the U.S. Treasury in order to satisfy the required transfer of funds from the Capital Reserve Account to the Financing Account to meet expected claim obligations. Instead, at the end of FY 2012 the Capital Reserve Account held $3.3 billion – even after the transfer for these expected costs. The fact that the MMI Fund ended the year with this balance is due primarily to policy changes made during the fiscal year that substantially improved the value of the Fund. Likewise, the series of additional changes FHA has announced and which are described below are designed to reduce the likelihood that FHA will need to draw on Treasury assistance at the end of FY 2013.

We will continue, as we have throughout this Administration, to be diligent in taking every action appropriate to protect taxpayers while continuing to ensure that FHA supports the stabilization of the housing market, and that families have access to sustainable mortgage credit options.

II. The Role of FHA's Programs in the Nation's Housing Finance System

As we discuss the current status of FHA's programs and finances, it is important to frame this discussion within the context of the role FHA has played historically in the nation's housing finance system. Throughout its history, FHA has supported access to affordable, sustainable mortgage financing to persons and entities underserved by the conventional market. Through its single family, multifamily and healthcare loan guarantee programs, FHA has acted as a stabilizing force in the housing market during times of economic distress. At no time has this countercyclical influence been more pronounced than during the recent housing crisis. In the face of ongoing challenges in these sectors, FHA has continued to provide access to mortgage finance opportunities during a period of severe constriction in conventional markets. As a result, FHA has played a central role in bringing the housing market from the brink of collapse to a place where the outlook is positive and improving.

Since its inception in 1934, FHA has provided access to homeownership through its single family programs for credit-worthy lower wealth or otherwise underserved borrowers, enabling more than 40 million families who might otherwise have been prevented from doing so to realize the American dream of homeownership. In addition to providing access to financing for credit-worthy borrowers by insuring mortgage lenders against losses on defaulted loans, FHA's single family programs have also offered crucial liquidity in the mortgage finance system during periods of market stress. Whether providing ongoing credit availability in areas experiencing regional recessions, or ensuring nationwide liquidity during broader economic crises such as we have recently experienced, FHA has repeatedly acted as a vital stabilizing force in the single family mortgage market when constriction in conventional lending threatens effective functioning of the market.

Likewise, FHA's multifamily and healthcare programs have been very important to facilitating credit availability in their respective sectors. These programs provide critical mortgage financing opportunities that strengthen communities by addressing specialized financing needs including insurance for loans to develop, rehabilitate and refinance multifamily rental housing, nursing home facilities and hospitals. These sectors faced a severe contraction in the availability of conventional financing, as well as a near collapse of the tax exempt bond market, making FHA's programs essential. FHA multifamily and healthcare mortgage insurance programs operate under FHA's General Insurance-Special Risk Insurance (GI-SRI) Fund, which is separate and distinct from the MMI Fund used for single family programs.

III. FHA Single Family Programs

Created in the aftermath of the Great Depression and designed to expand access to homeownership that would in turn stimulate the ailing residential housing markets, FHA played a central role in developing today's mortgage finance system. It redefined mortgage underwriting practices so that qualified borrowers could obtain mortgage financing, and it standardized construction and appraisal requirements so that mortgage contracts could be tradable across the country. Even more important than FHA's contribution to developing modern mortgage standards and practices, however, has been its role as a countercyclical force that ensured continued liquidity throughout the mortgage finance system during periods of economic stress. This has been true on a number of occasions at the regional level as FHA has offered support for mortgage financing in specific geographies experiencing localized recessions, and much more so as FHA has played a prominent role in stabilizing the market and averting a total collapse of the housing market during the recent crisis. By design, FHA's programs are meant to complement, not supplant, private capital. It is there to combat a lack of available mortgage credit when private capital retreats or underserves markets, and to step back when private capital returns or expands to serve previously underserved populations. And because of this unique role, its business cannot and should not be evaluated on the same terms as a private firm, as such a requirement would force FHA to act as a private firm and therefore eliminate its value in providing countercyclical liquidity and credit to underserved markets.

A. FHA Single Family Activity in FY 2012

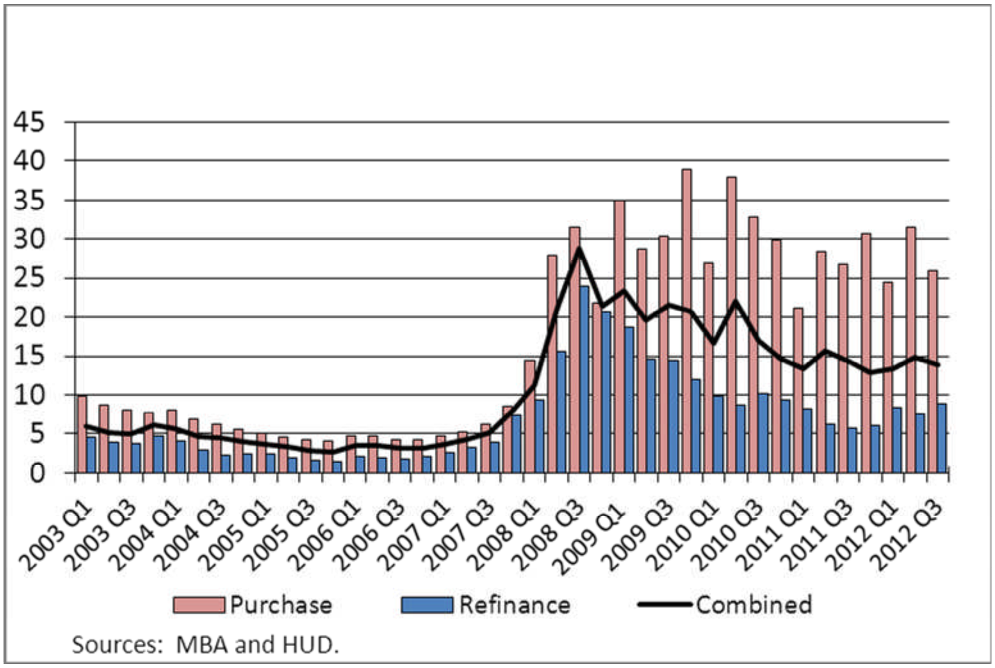
In 2012, FHA continued to play an important part in the ongoing recovery of the nation's housing market and broader economy. FHA insured nearly 1.2 million single-family forward mortgage loans during the year, with a total dollar value of approximately $213 billion. Of the over 700,000 home-purchase mortgages endorsed during the year, 78 percent were for first-time homebuyers, reaffirming FHA's role in providing access to new entrants to the home ownership market. Indeed, over the past four fiscal years, FHA has insured mortgages for over 2.8 million first-time buyers.

FHA has also continued to be a vital source of home financing for minority borrowers. While FHA insurance was used for approximately 27 percent of all home purchase mortgages in 2011, FHA accounted for 50 percent of home purchase mortgages for African American borrowers and 49 percent for Latino borrowers.

Clearly, FHA has played a very crucial role in facilitating continued liquidity in the single family mortgage finance market, preventing even more severe economic circumstances during the recession. As Moody's Analytics Chief Economist Mark Zandi said in a Washington Post article, "If FHA lending had not expanded after private mortgage lending collapsed, the housing market would have cratered, taking the economy with it." Moody's estimates that were it not for FHA's presence during the recent crisis, house prices would have fallen an additional 25 percent, resulting in 3 million more job losses and a reduction of economic output of $500 billion.

Although FHA continues to be an important source of access to credit for American families, its market share continues to decrease as the economy recovers and private capital begins to return to the market. New insurance endorsement activity in FY 2012 fell once again from that of the prior year, continuing its decline from the peak levels seen in FY 2009. In terms of dollars of single-family loans insured, 2012 is the lowest volume since the start of the crisis. Home Equity Conversion Mortgage (HECM) insurance endorsements in FY 2012 were also down by 25 percent from FY 2011 levels, to 54,591 loans. FY 2012 marks the third consecutive year in which HECM volume declined, as the combined effects of policy revisions to the product and changes within the industry have reduced participation in the program.

FHA Market Share as a Percent of Mortgage Originations by Type



FHA has served an important and necessary role in the nation's housing finance system throughout the past year. Because of the agency's importance to the overall health of the housing market and its responsibility to American taxpayers, FHA constantly seeks to balance efforts to provide access to credit for underserved borrowers and ensure continued liquidity in the system with its responsibility to prudently protect the health of the MMI Fund. Throughout the current Administration, we have continually sought such balance in establishing policies and practices for FHA.

B. The Mutual Mortgage Insurance Fund

The important services FHA single family programs provide to the nation's housing sector are made possible through FHA's Mutual Mortgage Insurance Fund. The MMI Fund operates with two primary sets of financial accounts:[1] a Financing Account, which reflects the business transactions related to insurance operations, and a Capital Reserve Account, which reflects secondary reserves for unexpected claim expenses. Both of these accounts are held at the U.S. Treasury. The Capital Reserve Account is unique to MMI Fund operations. It was established to assist in managing to the two-percent capital ratio requirement enacted by Congress in 1990. FHA's MMI Fund programs, however, are backed by the full faith and credit of the U.S. Government, and like all federal government direct-loan and loan-guarantee programs, its financing account operates with what is called "permanent and indefinite budget authority." This authority provides access to the U.S. Treasury for any funds needed to pay claim obligations, and provides assurance to lenders and

[1] There are two additional sets of accounts that are independent of the insurance operations, and for which funds are directly appropriated by the Congress each year. The first is the set of Program Accounts which cover all personnel and administrative expenses for FHA operations. The other is the Liquidating Account, which represents remaining cash flows each year on pre-1992 insurance endorsements. The year 1992 marks implementation of the Federal Credit Reform Act of 1990 and introduction of the Financing Accounts.

investors that FHA programs are never in jeopardy of lacking sufficient funds to pay insurance claims. That would be true even in the absence of a Capital Reserve Account.

The Fund is subject to two distinct portfolio valuations each year. Both project all future revenues and expenses based upon a forecast of loan performance under defined economic conditions. One is performed by an independent actuary in accordance with requirements of the National Housing Act, and the other is the annual subsidy re-estimate performed by the Administration under the terms of the Federal Credit Reform Act and published in the President's Budget.

The independent actuarial study uses statistical models to develop 30-year projections of default, claim, loss-on-claim, and prepayment rates on current and future books of business. Those models are estimated using historical patterns of FHA-insured loan performance under a wide variety of economic conditions. They are applied to active loans, and they use commercially-available forecasts of home prices and interest rates to predict loan performance in the future. The resulting projections determine business-operation cash flows needed to estimate the economic value of the Fund.

This year, the actuarial study applied a stochastic method to estimate the net present value (NPV) of future cash flows. The move to a stochastic method represents one of the advancements that have been made to the actuarial modeling process this year and is implementing recommendations by the GAO and the HUD OIG. In previous studies, the net present value of cash flows was computed along a single path of house prices and interest rates. This year, 100 equally likely paths were generated to develop a wide variety of possible economic conditions, creating what is known in mathematical terms as a Monte Carlo simulation. The discounted, net present value (NPV) of cash flows was computed for each path. They were then averaged to obtain an overall estimate of the expected NPV that provides the base-case estimate.

The outcome of the complete actuarial study modeling effort is the estimated "economic net worth" of the MMI Fund, which is defined by the National Housing Act as capital resources plus the present value of future cash flows of the MMI Fund. The calculation of economic net worth is repeated for each of the next seven years by adding projected endorsements each year, forecasting their cash flows and adding them to those of the current portfolio, and then reassessing economic net worth on the updated portfolio at the end of each fiscal year.

Economic net worth represents additional resources directly available to FHA for absorbing claim expenses above-and-beyond those already anticipated in the present-value-of-future-cash-flow calculations. Those calculations are for the remaining life of all outstanding loan guarantees and can extend for more than 30 years on HECM loans. Economic net worth is the numerator of the statutory capital ratio measure. The denominator is the outstanding dollar volume of active insurance contracts.

The credit subsidy re-estimate is performed each year as part of the federal budget process in accordance with the budget valuation of all federal direct loan and guarantee programs. For FHA single-family programs, this evaluation uses a modified version of the actuarial study forecasting model, applying the economic assumptions common to the President's Budget. The estimate is used to determine any necessary transfers between the MMI Fund Financing and Capital Reserve accounts, based on projections of expected claims and premium revenue on outstanding loan cohorts over their remaining lifetimes (up to 30 years). It is this estimate that establishes any expected need to draw on support from the Treasury to ensure possession of sufficient capital resources to meet all future expected claim costs. Permanent and indefinite authority from Treasury is only necessary if FHA is unable to satisfy the budget re-estimate requirements from the funds in the Capital Reserve at the end of the fiscal year.

C. The FY 2012 Actuarial Review

This fiscal year, as noted above, the MMI Fund capital reserve ratio fell below zero to negative 1.44 percent. The actuarial assessments estimate that the economic value of the Fund as of the end of FY 2012 is negative $16.3 billion against an active portfolio of $1.13 trillion. The economic value of the forward portfolio was estimated at negative $13.5 billion, the HECM portfolio at negative $2.8 billion. These economic values represent capital reserve ratios of negative 1.28 percent and negative 3.58 percent respectively. The actuary projects that the MMI Fund capital reserve ratio will be positive by FY 2014 and reach 2.0 percent during FY 2017 under its base-case estimate. These forecasts assume no changes in policy or other actions by FHA, including those that were announced when the actuarial report was released last month that might accelerate the time to recovery.

The low capital ratio today reflects an expectation that FHA's current pool of insured loans still has significant foreclosure and claim activity yet to occur. Projected losses are particularly large for the fiscal year 2007-2009 loans. Those loan cohorts were impacted by the severe recession and accompanying increases in unemployment, and by large volumes of seller-funded down payment loans. Indeed, loans insured from 2007-2009 are projected to yield more than $70 billion in claims for FHA.

Loans using seller-funded downpayment assistance have proven to place substantial stress on the Fund. Those loans are projected to cost the Fund $15 billion as they continue to experience elevated rates of insurance claim. In fact, the Actuary estimates that, if FHA had not insured any seller-funded-downpayment loans, the net economic value of the MMI Fund would be positive $1.77 billion today. Thus, we are very grateful for the action by Congress in 2008 to eliminate seller-funded downpayment loans from the FHA program, avoiding substantial additional losses from these loans.

In contrast to the drain caused by those older loans, the actuary expects endorsements in fiscal years 2010 through 2012 to produce significant net revenues that can be used to partially offset losses from earlier books of business. The contrast in quality between these two vintage eras—pre- and post-2009— is demonstrated by the following table.

Lifetime Economic Value by Endorsement Vintage (Forward Loans)

Vintage	Original Loan Balances ($billion)	Present Value of Premium Revenue	Present Value of Credit Losses	Economic Value (%)	Economic Value ($billion)
1992 - 2006	$1,190	3.5%	5.1%	(1.6%)	($19.5)[1]
2007 - 2009	564	3.8%	11.0%	(7.2%)	(40.6)
2010 - 2012	721	6.0%	2.9%	3.1%	22.7
Total	$2,475	4.3%	5.8%	(1.5%)	($37.4)

[1]1992-1999 cohorts were profitable, while 2000-2006 cohorts were not. The combined values of all cohorts yields the negative values shown here.

Source: FY 2012 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

While the general trends revealed in this year's actuarial report are consistent with those reported in the reports of the past few years – books of business insured through 2009 are placing a great amount of stress on the MMI Fund while those insured since 2010 are adding substantial value to the Fund -- the overall results in this year's actuarial report differ substantially from last year's projections on the status of the Fund at the end of this fiscal year. There are three factors driving the change in the estimated economic value of the MMI Fund compared to what was projected last year:

- First, the Moody's July 2012 house price appreciation forecast, which was used in this year's actuarial study, predicted significantly lower levels of appreciation in the near term than the forecast used in last year's actuarial study. This results in a cumulative difference in projected house price appreciation of 8 percentage points over the first five years. Thus, this downward revision in house price forecasts from last year to this year accounted for an estimated $10.5 billion in reduced economic value compared to the actuary's 2011 projection of what the Fund's economic value would be as of the end of FY 2012. Further, near-term house-price movements in the index used by the actuaries were depressed by high levels of refinance activity in 2012, and therefore, they do not reflect improvements seen this year to home prices in other measures of housing market strength. Additionally, because the forecast utilized only covers the period through June 2012, it does not include substantial improvements to home prices seen since that time. Second, the continued decline in interest rates since last year, while good for the overall economy, causes a substantial loss of revenue. The reasons for this are two-fold. First, because of the higher interest rates being paid by borrowers on loans made before 2009, the actuary projects that these borrowers will default at marginally higher rates than would otherwise be expected. Second, the actuary projects that FHA loans would be paid off earlier than expected through refinances that take advantage of the lower rates, and because the methodology required by statute that the actuary utilizes assumes that none of these loans will refinance back into FHA. The effect of these two assumptions by the actuaries resulting from a prolonged period of low interest rates is a reduction of $8 billion in estimated economic value for the Fund from what was anticipated in last year's report.
- Third, based on recommendations made by the GAO, HUD's Inspector General, at FHA's direction, the actuary employed a refined methodology this year to adjust the way losses from defaulted loans and reverse mortgages are reflected in the economic value of the MMI Fund, resulting in an estimated $13 billion in reduced economic value compared to last year's projections. Specifically, shares of Pre-foreclosure sale (PFS or short sales) and REO in claim predictions are now explicitly modeled, and each has its own loss rate forecast. PFS share of

claims is now less than half of what was implied in past models. Also, model structure changes removed an artificial cap on the effect of declining home prices on REO loss rates.

It should be noted that while the shift in value from what was projected last year to what was calculated in this year's review is substantial, last year's actuarial report did indicate that should house price appreciation or interest rates deviate from the base case scenario used for the actuary's projections, such deviations would impact the Fund's value in FY 2012. Furthermore, last year's report stated explicitly that there was an approximately 50 percent chance that if economic forecasts differed from those used in the FY 2011 report the Fund would have a negative value. These findings were the result of stress testing requested by HUD. While stress tests are not required by statute, FHA directs the actuary to perform them annually to provide greater insight into what may be expected if conditions deviate from those envisioned in the base case scenario. This year, FHA asked the Actuary to estimate the value of the Fund based upon those economic paths that yield the 10th best, 25th best, 25th worst, 10th worst and the singular worst projected economic values. Additionally, the Actuary was also asked to evaluate two additional scenarios which represent singular, deterministic economic paths with no random fluctuations. First was the Moody's Protracted Slump Scenario, the most stressful alternative scenario forecasted by Moody's Analytics in July 2012. Second was a Low Interest Rate Scenario, representing a continuation of the historically low interest rate environment prevailing at the end of FY 2012.

The significant shift in dollar value this year from what was expected in last year's report highlights the volatility associated with thirty year projections of economic conditions. Additionally, they are indicative of what occurs when underlying factors change for a portfolio the size of FHA's. The $23 billion difference between the estimated value of the Fund in this year's actuarial review versus that projected in last year's represents only a 2 percent shift in value.

D. Actions Taken to Date to Protect the Fund

Throughout the tenure of this Administration, FHA has taken aggressive and decisive actions to improve the health and trajectory of the MMI Fund, while ensuring continued access to mortgage credit for American families. The changes made to FHA policy since 2009 are projected to have improved the economic value of the Fund by at least $20 billion. That FHA's capital ratio has remained positive until this year is primarily due to the reforms to risk management, credit policy, lender enforcement, and consumer protections made over the past four years – the most sweeping changes to policy in FHA's nearly 80 year history. Our efforts to date to strengthen FHA have been focused on eliminating unnecessary risks and ensuring sufficient revenue generation from new endorsements while continuing to learn from what is working in our efforts to improve FHA's asset management and loss mitigation approaches.

1. Counterparty Risk Management and Lender Enforcement

Toward these ends, one of the first things this Administration did upon taking office was to take strong actions to improve FHA's monitoring and oversight of lenders. This has included substantial improvements to risk analysis systems and procedures, and policy changes to focus resources on the areas of FHA's business which pose the greatest potential risk to the MMI Fund. These efforts have resulted in record numbers of lenders being withdrawn from FHA programs, substantial improvements in lender compliance with FHA requirements, and a number of settlements with lenders and servicers for violations of FHA origination or servicing requirements.

2. Credit Policy

We have also worked to strengthen our credit policies for FHA borrowers. First and foremost, FHA implemented Congress's elimination of seller-funded downpayment assistance programs which cost the MMI Fund more than $15 billion in economic value. Further, we enacted increased downpayment requirements for borrowers with credit scores below 580. The long-term positive impact of these two credit policy changes cannot be overstated. The 2005 – 2008 vintages, accounting for less than 15% of total originations over the last 30 years, are projected by the Actuary to contribute more than one-third of total credit losses of the Fund. Loans with credit scores below 580 and/or seller-funded downpayment assistance will have accounted for 44% of those losses. Additionally, we have worked to reduce the amount of allowable seller concessions that increase risks to FHA arising from inflated appraisals. Together, these measures will better ensure that home buyers using FHA-insured financing are capable of meeting their mortgage obligations and won't put undue stress on the Fund.

3. Increased Revenue

In addition to the improvements made to the quality of new endorsements, we have also made the difficult choice to increase mortgage insurance premiums for FHA-insured loans multiple times in the past four years. Since 2009, FHA has increased premiums four times – the most recent increase coming in response to the FY 2011 actuarial review. Combined, the premium increases made since 2009 have yielded more than $10 billion in additional economic value for the Fund. These increases have not been undertaken lightly, and FHA has been careful to balance changes to pricing to improve the outlook of the Fund with its countercyclical role of providing liquidity and access to credit in the midst of the recent crisis and ongoing recovery.

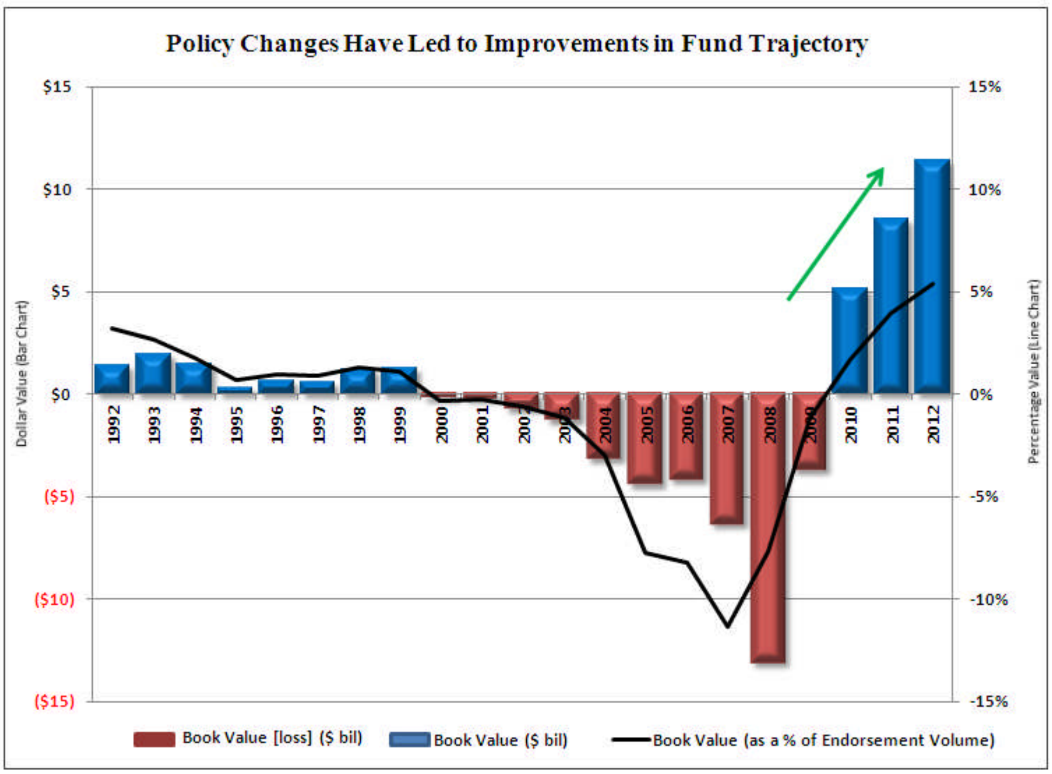
4. Loss Mitigation and Asset Management

FHA has not just addressed issues associated with the origination of new loans, but has also taken decisive steps to control costs and limit losses on the back end of its business through improvements to its REO disposition processes and loss mitigation strategies. First, we changed our strategy and approach with regard to the REO management and marketing contracts through which FHA's REO property inventory is managed and sold. Enhancements to the oversight of contractors and better monitoring of their compliance with FHA guidelines, as well as measures which promote competition and continuity within specific markets, have resulted in notable improvements to FHA's REO processes. As a result of the changes HUD has made, the gap between appraised values of REO properties and their sales prices has decreased by 62% and the time in inventory for FHA properties has reduced by 45%, decreasing losses on the REO portfolio and improving recoveries for the Fund.

Finally, in FY 2012, FHA implemented a significant expansion of its note sales program whereby non-performing loans are sold in pools at a market-determined price via auction to investors, who are then able to explore options for homeowners to either remain in their homes or obtain a viable non-retention solution. This initiative, known as the Distressed Asset Stabilization Program (DASP), exponentially expands the number of loans sold in each sale while introducing innovations designed to promote stability in hard hit geographies. In addition to the sale of pools comprised of properties located throughout the nation, FHA also created Neighborhood Stabilization Pools of loans concentrated in specific Metropolitan Statistical Areas (MSAs). For the first sale in this expanded program, the MSAs of Newark, Tampa, Chicago and Phoenix were selected for inclusion in the program. These pools included additional requirements targeted at reducing the inventory of vacant foreclosed properties in these communities and providing enhanced options for homeowners and community members to benefit from these properties that would otherwise end up in FHA's REO inventory. The initial results from the first DASP sale were positive, resulting in the Actuary's estimate of improved economic value for the Fund from this initiative of more than $1 billion over the next two years.

The effectiveness of these changes can be seen in the stark contrast between books of business insured prior to 2010 and those insured since that time, which is clear in the graph below.

Economic Net Worth by Book-of-Business



Source: FY 2012 Actuarial Reviews of the MMI Fund; analysis by U.S. Department of HUD/FHA.

E. Actions to Be Taken in FY 2013

While FHA has enacted substantial reforms under the current Administration, this year's actuarial review makes clear that loans made prior to and at the outset of the recent crisis continue to weigh heavily on the health of the MMI Fund. Therefore, building upon the significant efforts already undertaken to protect and preserve the MMI Fund, FHA is implementing a series of additional actions to continue improving the Fund's trajectory over both the short and long term. Using the Actuary's model, collectively, these changes are projected to provide billions of economic value for the MMI Fund in FY 2013.

1. Reduce Losses from Legacy Books of Business

The changes made since 2009 to FHA's lender oversight, credit policies, and premium pricing have yielded substantial improvements in the quality of new loans endorsed by FHA. But significant opportunity remains to reduce the impact on the Fund of poorly performing legacy loans severely impacted by the recession, and to provide greater assistance for distressed borrowers as they seek to recover and find meaningful assistance in dealing with their delinquent loans. With a majority of FHA's projected losses attributable to loans insured from 2007-2009, FHA will take several additional steps to maximize recovery in the areas of loss mitigation and asset management.

The Actuary projects nearly $60 billion in claims costs for FHA from seriously delinquent loans that will go to claim by the end of FY 2014, largely arising from loans insured between 2007 and 2009. As a result, reducing the severity of losses derived from these loans will exert a demonstrable positive impact to Fund performance over the next few years. Throughout the past fiscal year, FHA has been executing on an overall asset management strategy aimed at ramping up REO alternatives. REO alternatives (primarily short sales) comprised about 15%-20% of total dispositions since 2010, yielding average loss severities about 20% lower than REO. In recent months, as noted, FHA also unveiled its Distressed Asset Stabilization Program (DASP), another REO alternative that improves Fund performance. These and other actions have had a measurable effect, as loss severities have already fallen by 9% in the last year A further reduction in loss severities will further improve fund performance.

- **Re-design of FHA Modification Treatments to Better Assist Delinquent Homeowners**
  FHA issued a Mortgagee Letter on November 16, 2012 that established revised standards for repayment plans, standard modifications, and FHA-HAMP loss mitigation products, which are expected better assist distressed borrowers and reduce losses to the Fund from foreclosures. FHA loss mitigation policies will be geared towards greater payment relief for borrowers, targeting payment reductions of at least 20% for FHA-HAMP modifications, which will result in more sustainable payment outcomes for borrowers over the long term. This approach will yield lower claim costs for FHA while also reducing prepayment speeds for insured loans, both of which will positively impact the MMI Fund.

- **Streamlining of the FHA Short-sale Policy**
  Although FHA is deeply committed to providing loss mitigation alternatives to borrowers which permit them to retain their homes, home retention is simply not an option for some borrowers. For these borrowers, pre-foreclosure sales (short-sales) offer an opportunity to transition out of their homes. This enables both FHA and the borrowers to avoid the costs and damages of the foreclosure process. FHA will introduce a streamlined pre-foreclosure sale policy which removes certain barriers for borrowers in obtaining a short sale on their FHA-insured mortgage. This change is expected to increase the number of defaulted loans that end in short sales rather than foreclosures. Because losses from short-sales are substantially lower than from the traditional FHA REO process, the shift of greater numbers of distressed homeowners to short-sale dispositions rather than foreclosures will yield

better results for the MMI Fund while allowing distressed borrowers to start anew without having to go through the difficult and costly foreclosure process.

- **Claim without Conveyance Pilot Program**
  FHA is conducting a pilot whereby properties secured by non-performing FHA-insured loans are offered for sale by the lender who has completed the foreclosure process. At a reserve price slightly below the outstanding unpaid principal balance of the loan, the properties are sold to third party purchasers without ever being conveyed to FHA. This method of disposing of these properties may yield lower losses for the MMI Fund than selling them through FHA's normal REO disposition process, as carrying costs associated with preserving, managing, and marketing an REO property were eliminated.

- **Proactive Strategies to Further Improve Recoveries**
  In addition to the policy and programmatic changes outlined above, FHA will also take several innovative and proactive steps to increase utilization of loss mitigation options and reduce unnecessary asset disposition losses. First, beginning in 2013, FHA will launch a large-scale proactive marketing campaign to promote modification and short-sale strategies for delinquent borrowers. This effort is expected to increase utilization of these programs, which will permit more borrowers to become aware of and take advantage of these opportunities, while reducing foreclosures and decreasing associated losses for FHA. In addition, FHA will also pursue more creative strategies to dispose of REO properties in geographies where traditional asset disposition methods yield net negative recoveries for FHA. This approach will both save money for FHA on unnecessary losses as well as contribute to community stabilization initiatives in cities hit hard by the recession.

2. Further Strengthen the Quality and Impact of New Endorsements

While much has been done under the current Administration to improve the performance and revenue of new FHA endorsements, we believe it is vital to take additional steps to strengthen new books to ensure the long term health of the MMI Fund. Accordingly, in the second quarter of FY 2013, FHA will implement the following policies for new originations.

- **Revised Premium Cancellation Policy**
  Under a policy change made in 2001, FHA has been cancelling required mortgage insurance premiums (MIPs) on loans for which the outstanding principal balance reaches less than 78% of the original principal balance. However, FHA remains responsible for insuring 100% of the unpaid principal balance of a loan for the entire life of the loan, such loan life often extending far beyond the cessation of MIP payments. As written, the timing of MIP cancellation is directly tied to the contract mortgage rate, not to the actual loan LTV. The current policy was put in place at a time when it was assumed that home price values would not decline, but today we know that LTV measured by appraised value in a declining market can mean that actual LTVs are far lower than amortized mortgage LTV, resulting in higher losses for FHA on defaulted loans. Analyses conducted by FHA's Office of Risk Management projects lost revenue of approximately $10 billion in the 2010-2012 vintages as a result of the current cancellation policy. The same analyses also suggest that 10%-12% of all claims losses will occur after MIP cancellation. Therefore, beginning with new loans endorsed after the policy change becomes effective later in FY 2013, FHA plans to once again collect premiums based upon the unpaid principal balance of FHA loans for the entire period during

which they are insured, permitting FHA to retain significant revenue that is currently being forfeited prematurely.

- **MIP Increase**
  We are very grateful for the flexibility Congress granted us in 2010 to adjust FHA's premium pricing. And we have utilized that flexibility three times already. This fiscal year, we plan to use it once again as, consistent with FHA's continued efforts to balance its countercyclical role in the nation's mortgage market with its responsibility to manage the Fund, FHA plans to increase annual mortgage insurance premiums by an additional 10 basis points. While the new loans being made today are profitable to FHA and we do not want to over-burden or constrict access to credit as the housing market continues to mend, we also must ensure that we are 1) rebuilding adequate reserves for the future and 2) phasing out of our counter-cyclical role by reducing FHA's footprint in the marketplace and helping to facilitate the return of private capital. FHA has played a vital part in ensuring access to credit for borrowers and liquidity in the market, yet its current outsized role should and will decrease. Indeed, its market share has declined yearly since a peak in 2009. This premium increase – $13 per month for the average FHA borrower – which FHA plans to implement in 2013 will add significant revenue to the Fund and ensure that FHA does not take on additional market share, while at the same time being modest enough that it doesn't impact borrower access to credit or threaten our emerging housing recovery.

- **Future Credit Policy and Pricing Changes**
  While much has already been done to improve the quality of new FHA endorsements, the effectiveness of which are clear in the performance and projected value of loan cohorts insured since 2010, FHA is continually evaluating its portfolio to identify and mitigate risks, and to provide enhancements that benefit both consumers and the Fund. Based upon these evaluations, FHA is also developing additional proposals which will further assist in strengthening the MMI Fund.

- **Housing Counseling Incentive Policy**
  Significant evidence has shown that housing counseling improves the success of home buyers – particularly first time homebuyers.[2] FHA intends to develop new policies which incentivize, or in some cases require, borrowers to complete a pre-purchase housing counseling program prior to the purchase of a home using FHA-insured financing. We will work during this fiscal year to craft and receive feedback on the precise contours of this initiative. This endeavor is expected to ultimately improve outcomes for both borrowers and FHA, reducing losses to the Fund as higher numbers of new borrowers attain successful home purchases.

[2] HUD conducted a review of pre-purchase counseling that was published in 2012, which also found that the program was serving its intended population. The study tracked 573 participants at 12 to 18 months after receiving pre-purchase counseling services. Only one of the purchasers had fallen at least 30 days behind on his or her mortgage payments and none had a major derogatory event on a mortgage account. A report on the study's findings can be found at:
http://www.huduser.org/portal/publications/hsgfin/pre_purchase_counseling.html

3. Stabilize and Strengthen the HECM Program

Changes in borrower utilization of the HECM program and the modeling changes employed by the actuary this year show substantial stress in the HECM program. In order to mitigate the negative impact of the 2013 and future HECM books on the MMI Fund, FHA is taking aggressive actions in both the near and long terms to ensure that consumers are better protected and able to sustain their reverse mortgage, while also protecting the Fund.

- **Immediate Steps to Reduce Losses in the Near Term**
  Given current regulatory authority, FHA has limited ability to address root cause issues and will, therefore, be forced to make blunt changes to the program on an interim basis. FHA will take immediate action to better align the program with its objective of enabling seniors to age-in-place. These changes will protect FHA from losses and reduce the likelihood of borrower defaults due to nonpayment of property taxes and insurance.

  In addition, FHA will consolidate the Fixed Rate Standard program with the Fixed Rate HECM Saver product, resulting in a reduction of the maximum amount of funds available to a HECM borrower. Further, the principal limit factors that are used to determine the maximum amount a homeowner may borrow using the remaining HECM products will be reduced across the board (i.e. Fixed/ARM Saver, ARM Standard).

  Additionally, in an effort to reduce losses associated with the conveyance and disposition of properties mortgaged with a HECM, FHA will issue new incentives for estate executors of HECM borrowers to dispose of properties themselves rather than conveying them to HUD. Executors are permitted to either sell such properties or convey them to HUD. Reversing the historical trend, over the past few years, larger numbers of executors have been choosing to convey these properties to FHA rather than sell them, adding costs and reducing recoveries for FHA. By incentivizing the sale of properties by executors, FHA is able to avoid property management, maintenance, and marketing costs associated with the REO disposition process, thereby reducing losses to the Fund on these properties.

- **Longer-term Changes to Permanently Strengthen the Program**
  Over a longer term, either through the granting of the legislative authority described below or via the much longer rule making process, FHA will also pursue other material changes to ensure the long-term viability of the HECM program. These measures include:
  - Limiting the draw at origination to mandatory obligations (i.e. closing costs, mortgage liens and federal debt), providing greater flexibility in addressing the individual needs of borrowers than the across-the-board reductions to principal limit factors described above, while still protecting the Fund from losses on loans where the maximum loan amount is drawn up-front;
  - Performing a financial assessment of borrowers as a basis for loan approval and determining the suitability of various HECM products to protect consumers from acquiring loans not fit for their situation; and
  - Establishing a tax and insurance set-aside to ensure sufficient equity or an annuity is available to pay taxes and insurance on the mortgaged property so that defaults resulting from nonpayment of taxes and insurance can be avoided.

F. Legislative Requests to Further Strengthen the Fund

Throughout the past four years, Congress has moved in important ways to strengthen and protect FHA, and for that we are very grateful. Indeed, were it not for the flexibility granted by Congress to FHA in 2010 in setting premium pricing, the current economic value of the MMI Fund would be more than $10 billion lower than it is today. And the work this body has done to establish FHA's first ever Office of Risk Management has been instrumental to our improved ability to identify risks in FHA programs and take action to mitigate them. So thank you for your commitment to making FHA stronger and more secure over the long term.

But today, we are asking for your help once again so that FHA is better able to protect the Fund while continuing to execute its mission. The proposals outlined below will enhance FHA's ability to hold lenders accountable for non-compliance with FHA policy and provide greater flexibility for FHA to make changes to policies and procedures as emerging needs and trends are identified. As a result, FHA will better be able to avoid unnecessary losses before they occur.

1. **Indemnification Authority for Direct Endorsement Lenders:** This provision, which FHA has been seeking since 2010, would allow FHA to seek indemnification from Direct Endorsement lenders, which represent 70% of all FHA approved lenders. Currently FHA only has authority to require indemnification for lenders with Lender Insurance (LI) approval. In granting this authority, FHA will be able to obtain indemnification from all of its approved lenders for loans that do not comply with its guidelines.

2. **Revised Indemnification Authority**: This change would eliminate the "knew or should have known" standard with regard to fraud or misrepresentation. While the Government-Sponsored Enterprises require lenders to retain all fraud related risk, FHA only holds lenders accountable for fraudulent activity if they "knew or should have known" of its occurrence. Providing proof to meet this standard limits FHA's ability to require lenders to be accountable for fraud in FHA-insured loans, and its removal would significantly improve FHA's ability to avoid unnecessary losses arising from fraudulent activity.

3. **Authority to Terminate Origination and Underwriting Approval:** This legislation would give FHA enhanced ability to review lender performance and, if a lender is found to have an excessive rate of early defaults or claims, would provide greater flexibility in terminating the approval of the lender to originate or underwrite single family mortgages for FHA insurance. FHA has been seeking this authority since 2010.

4. **Revised Compare Ratio Requirement:** This provision would revise the statute governing the Credit Watch Termination Initiative to provide greater flexibility in establishing the metric by which FHA compares lender performance so that it more effectively captures the true performance of a lender during all market conditions, minimizing further poor performance by FHA lenders while reducing uncertainty for them. Specifically, this legislation would allow the Secretary to compare the rate of early defaults and claims for insured single family mortgage loans originated or underwritten by a lender with those same rates for other lenders on any basis the Secretary determines appropriate, such as geographic area, varying underwriting standards, or populations served. Further, the provision would permit the Secretary to implement such comparisons via regulations, notice, or Mortgagee Letter. This will allow FHA to tailor the compare ratio such that it provides meaningful comparisons of lenders in varying

market conditions, providing greater clarity for lenders and a more refined understanding of their performance for FHA.

5. **Authority to Transfer Servicing:** In order to facilitate more effective loss mitigation, this change would give FHA the authority to require any of the following actions when a servicer is at or below a servicer tier ranking score (TRS) of III, or when the Secretary deems the action necessary to protect the interests of the MMI Fund: (1) transfer servicing from the current servicer to a specialty servicer designated by FHA; (2) require a servicer to enter into a sub-servicing arrangement with an entity identified by FHA; and/or (3) require a servicer to engage a third-party contractor to assist in some aspect of loss mitigation (e.g. borrower outreach). Such authority would permit FHA to better avoid losses arising from poor servicing of FHA-insured loans, yielding better results for both borrowers and FHA.

6. **Authority to Manage the HECM Program by Mortgagee Letter:** This provision would allow FHA to take specific actions via Mortgagee Letter to more effectively manage the HECM program. In light of the HECM portfolio's sensitivity to changing market conditions, this change would provide FHA with the flexibility to make necessary changes as soon as trends or issues are identified within the HECM program.

IV. FHA Multifamily Programs

The use of FHA MF programs increased exponentially during the crisis, providing needed liquidity in the market for MF residential and affordable mixed use buildings despite general constriction in credit markets. FHA has steadily provided liquidity in the market over the past several years in which conventional financing has not been readily available. With historically low interest rates, FHA has seen exponential growth in this area.

Multifamily Units Created During the Crisis:

Basic FHA Initial Endorsements for New Construction of Apartment Units			
FY	# Projects	# Units	Volume ($ millions)
2012	175	27,546	2,714.2
2011	189	30,483	3,080.6
2010	205	37,391	3,767.1
2009	90	15,195	1,363.8
Totals	659	110,615	$10,925.7

Today, as the market recovers, we are beginning to see private capital return to the market and expect to see a reduction in our share of new market rate units. FHA will continue to play a vital role in the creation and preservation of affordable housing and will continue to implement policies that balance risk and improve processes.

A. Risk Management for FHA Multifamily Programs

1. **MIP Increase**

As part of the broader efforts in the Office of Housing since the start of this Administration, FHA has taken a number of comprehensive steps to improve its risk management capabilities and processes. These actions were carefully crafted to balance the mission of FHA and its role in the broader credit marketplace. FHA Multifamily provided critical liquidity to the marketplace during the recession and during that time (from 2008 to 2011) FHA volume increased five-fold. The GI/SRI funds provide financing for the FHA multifamily and healthcare loan guarantee programs, as well as several very small specialized loan products. These accounts also continue to hold a sizable portfolio of single family loan guarantees (HECM, condominium, and rehabilitation loans) insured prior to FY 2009 when responsibility for new lending under these programs was transferred to the Mutual Mortgage Insurance Fund. Given the unprecedented increase in the number and dollar volume of loans insured under the GI/SRI, particularly with respect to market rate loans, the Department implemented premium increases for programs in the GI/SRI. This was the first premium increase in 10 years for these programs. Also, private capital is returning to the multifamily lending marketplace. We want to encourage this private capital to continue to return. In order to do this we need to be sure that our FHA products are not underpriced relative to what is available in the private market.

The MIP increases range from 5 basis points for 223(a)(7) refinancing to 20 basis points for 221(d)(4) new construction or rehabilitation activity. The increase premiums will have no impact on either development costs or rents. And, as the Department monitors the programs, the impact of implementing the proposal, and the interest rate environment, the Department will consider adjusting the premiums as appropriate. Also worth noting is that premiums for affordable housing projects (such as those with HUD rental subsidies and low income housing tax credits, as well as those insured under FHA risk-sharing programs) were not increased.

Cohorts 2012 and 2013 Mortgage Insurance Premium Comparison

Multifamily Programs	Cohort 2012 Annual MIP	Cohort 2013 Annual MIP [1]
Apartments NC/SR (221d4)	**0.45%**	**0.65%**
221 d3 NP coop owned apts. (221(d)(3)	**0.80%**	**-**
Apartments Refinance (223(a)(7) & 223)(f)	**Both: 0.45%**	**223a7: 0.50% 223f: 0.60%**
241a Supplemental loans for Apts. (241)(a)	**0.80%**	**0.95%**
HFA Risksharing	**0.50%**	**0.50%**
GSE Risksharing	**0.50%**	**0.50%**
Other Rental - includes sec. 207MHP, sec. 231 and sec. 220	**0.50%**	**0.70%**
Tax Credits	**Non-risk-sharing: 0.45% Risk-sharing: 0.50%**	**Non-risk-sharing: 0.45% Risk-sharing: 0.50%**

It is important to note that the elevated role FHA is currently playing in the market is temporary. The new premium structure in these programs brings FHA's pricing more in-line with the private mortgage insurance industry and enables more robust private competition while continuing to ensure sufficient levels of available capital in these sectors. The increase in premiums also reflect new realities – the Multifamily annual book of business is five times greater than it was just three years ago, and the risk profile has changed dramatically. FHA's multifamily apartment portfolio is now more than 50 percent market rate by unit count and 70% by unpaid principal balance (UPB), which adds a new component of risk, and a need to take steps to ensure the future viability of the portfolio. These risks are not yet fully captured by historical claim and default trends because they are too new to have matured as risks to the portfolio. Further, because of historically low rates, it is likely that we will own these risks for an extended period of time given the unlikehood that borrowers will refinance out of historically low rates and may have difficulty refinancing when interest rates rise over time.

2. Loan Committees

FHA Multifamily has also implemented a new loan committee approval process, aligning Hub and Program Center commitment authority and practice to ensure consistency in underwriting throughout the regional offices, as well as to provide a platform to share best practices. Loan committees at the Hub and National levels provide oversight for high risk transactions in the multifamily insurance program, based on loan size and a project's number of units. Loan committee approval processes are standard practice in the lending community and are an important tool to prudently manage credit risks and ensure the integrity and stability of the GI/SRI insurance fund. The Loan Committee has also proven to be an effective tool for increasing communication and a more consistent FHA platform.

3. Large Loan Policy

The Department has implemented more stringent underwriting and owner experience requirements for large loans, generally over $40 million for new construction and $50 million for existing refinances. This policy addresses the risk of "single point failure" by more conservative loan ratios for large market rate loans and a higher threshold of owner experience and financial strength. The Department's Large Loan Policy mirrors other industry best practices but still provides attractive leverage and terms. Our volume after implementation of this policy has seen a modest decline in the number of market rate new construction loan requests, and an overall safer book of business for loans underwritten to its requirements.

4. Revisions to Loan Documents: Increasing Accountability For Borrowers and Lenders

The Multifamily documents have been revised for the first time in decades to reflect modern day lending practices and to provide more accountability for both Borrowers and Lenders participating in Multifamily FHA programs. The documents now more clearly set forth contractual responsibilities and obligations of all parties and will enhance the Departments ability to enforce against parties in violation of business agreements. This will improve the ability of the Department to intervene more effectively to execute workouts for projects in contractual or financial violation, thereby mitigating the potential risk of claim and further protecting FHA exposure to loss.

5. Project Capital Needs Assessments (PCNA) Enhanced Guidance

The Department has published guidance incorporating industry feedback on how owners should conduct capital needs assessments for projects insured under FHA programs. The guidance aligns physical inspection standards for various programs and offices within HUD; ensures sufficient funding for replacement of building components, particularly for older properties; and addresses FHEO Accessibility issues.

6. Breaking Ground: Complete in all Multifamily Office and Delivering Results

Breaking Ground created extensive tools to monitor and access credit for Multifamily insured loans. Tools include a stronger credit review of borrowers; an early warning system that targets loans early in the process that do not meet FHA underwriting criteria; and a dashboard monitoring tool that monitors accountability of field offices; and establishment of a queue in order to more efficiently manage workload and provide greater transparency to lenders. Breaking Ground has produced results. Survey results demonstrate that staff morale has improved in the majority of field offices, with over 83% of HUD multifamily staff believing that the program helped their office become more effective and efficient. Almost 90% of staff now feel encouraged to come up with new and better ways of doing things. In terms of processing efficiency improvements, offices that had large application backlogs prior to Breaking Ground have begun to methodically clear out older applications, evidenced by the number of applications in process for over 90 days dropping from 191 to 50 in just seven months. In addition, offices that began Breaking Ground without a large backlog have begun to meet aggressive application processing time cycles established by the Office of Multifamily Housing. The Department will continue to track these metrics and look forward to reporting on these results.

7. Sustaining Our Investments: A Multifamily Asset Management Sister Initiative to Breaking Ground

The Department has launched Sustaining Our Investments, an initiative that focuses on Risk Based Management of the portfolio allowing project managers at both the Headquarters and field level to focus day to day operations on managing at-risk loans in the portfolio. Risk based reports keyed on financial and physical risk triggers direct project managers to act early on potential problems with particular assets. The first step in this initiative is completing a full ranking of FHA's entire multifamily market rate portfolio.

8. Low Income Housing Tax Credit Pilot

The Department launched a new program to facilitate the underwriting of FHA insured loans on transactions that include Low Income Housing Tax Credit equity. The pilot provides a more efficient delivery system for affordable housing by focusing on training Senior Underwriters to process loans that meet specific qualifying criteria and risk characteristics. The Tax Credit Pilot program will enable HUD to better meet our goals to finance affordable rental housing. Focusing on refinance and repair of existing properties, the Tax Credit Pilot offers a streamlined process and a staffing structure that meets industry best practices and allows HUD to focus on critical risk-based underwriting. In September, the program was expanded from a limited pilot geography to nationwide. I am pleased to report that we will endorse the first two loans under the program within the next month. These two loans were completed in less than half the processing time of our conventional program structure. With nearly two dozen loans in the pipeline under the Pilot program, we expect to see similar outstanding results using this new tool for financing and preserving affordable housing.

B. Legislative Requests

As part of the Fiscal Year 2013 Budget, HUD is seeking legislation to facilitate lending to small multifamily properties which are an important provider of affordable, but unsubsidized, housing for low and moderate-income families. According to the 2010 American Community Survey, nearly one-third of renters live in 5 to49-unit buildings. These buildings also tend to have lower median rents than do larger properties: $400 per month for 5 to 49 -unit properties as compared to $549 per month for properties with 50 ormore units. Because they are expensive to finance, particularly in this environment, these properties are at risk of divestment.

HUD is proposing two legislative changes: (1) first, changes to the Section 542(b) Risk Share program that would allow the Department to explore flexibility with the 542(b) Risk Share program to work with experienced affordable housing lenders to make Risk Share loans to small properties; and second, changes that would allow Ginnie Mae to securitize risk share loans under Section 542(b).These changes would allow HUD to enter into Risk Share agreements with qualified lenders – such as well-capitalized Housing Finance Agencies or Community Development Financial Institutions – that have demonstrated experience making loans to support affordable housing and neighborhood stabilization. Under these Risk Share agreements, qualified lenders could make refinance, acquisition or rehab loans available to small (5 to 49 -unit) properties. Lenders approved by Ginnie Mae could then securitize those loans on the secondary market, increasing the availability of capital for more multifamily lending. HUD's proposal to improve the resources available to small building owners is part of the Department's broader commitment to re-balance the nation's housing policy to support rental housing and neighborhood revitalization. These changes will provide small property owners with the same access to our Risk Share program as other multifamily property owners currently have. As Federal and state budgets shrink and the need for quality, affordable rental housing is on the rise, it's critical that we support small businesses who are finding solutions that work for families and for local economies. We look forward to working with Congress to ensure the availability of these unsubsidized, affordable housing units.

HUD is also pursuing legislative authority to allow Ginnie Mae securitization for 542(c) Risk Share loans. The 542(c) program currently serves state and local housing financing agencies whereby FHA "shares the risk" but allows the HFA to set the underwriting standards and monitor the loan. This proposal is strongly supported by the HFAs because of the long-term structural collapse of the municipal bond market that has severely constrained HFAs' access to capital and substantially increased HFAs' cost of capital.

V. <u>FHA Healthcare Programs</u>

FHA has steadily provided liquidity in the market during times of economic constriction. Combined with historically low interest rates, FHA has seen exponential growth in this area. FHA issued a record number of $6.5 billion in commitments in Fiscal Year 2012. FHA's healthcare programs for hospitals and residential care facilities (nursing homes, assisted living facilities, and board and care homes) have helped private lenders fill the gap left with the shrinkage of the conventional finance resources. And while this market seems to be rebounding, we continue to expect high levels of mortgage insurance activity for Fiscal Year 2013. As of September 2012, the FHA's portfolio of healthcare loan guarantees had an unpaid principal balance of $29.0 billion on 2,957 loans and counting.

A. Evolution of FHA HC Programs – Balancing Risk and Improving Processes

The increased activity within FHA's healthcare programs have brought in positive risk management changes to both balance risk and improve processes. Given the unprecedented increase in the number and dollar volume of loans insured under GI-SRI, in Fiscal Year 2013, premium increases for FHA's General Insurance and Special Risk Insurance healthcare programs were instituted to protect capital reserves and increase the stability of the insurance fund. With the premium increases, FHA Healthcare loans are priced more appropriately to encourage the return of private capital while, at the same time, continuing to ensure sufficient levels of available capital in these sectors.

In FHA's Office of Healthcare Programs, weekly loan committees are held to review and approve loan submissions and to monitor healthcare industry trends and risks. By implementing proactive asset management using early intervention monitoring tools, the Office of Healthcare Programs succeeded in maintaining very low claim rates in both healthcare facility mortgage insurance programs in Fiscal Year 2012.

LEAN Business Process Reengineering has also played an integral part in streamlining business operations within FHA's healthcare programs. Despite volume increases, LEAN Processing improvements reduced loan processing times while increasing risk management efforts. Revised program requirements and documents were established to enhance accountability for borrowers, operators, and lenders. To further manage risk in the healthcare portfolio, in areas of large risk concentrations, such as insuring portfolios of multiple healthcare facilities, reviews are conducted at both the corporate and individual loan levels. In the residential care facility mortgage insurance program, implementation of a Master Lease Structure to cross-collateralize properties not only works to improve the overall risk profile of FHA's healthcare portfolio, but ultimately reduces claims.

The Office of Healthcare Programs is in ongoing collaboration with HHS, CMS, and state public health departments to support efforts to ensure quality of care for the most vulnerable populations. Also, by incorporating state survey inspection results, cost reports, and data from other federal and state agencies into FHA's underwriting and asset management procedures, the shared utilization of data and cross-collaboration has been instrumental in keeping healthcare claim rates low within FHA.

B. Legislative Request

As part of the efforts of FHA's Healthcare programs to strengthen communities by addressing specialized financing needs, HUD is seeking passage of the language in the THUD Appropriations Bill to permit rural Critical Access Hospitals to be eligible for FHA insurance.

We are appreciative of the Congress' long standing support for Critical Access Hospitals by amending Section 242 to permit these important facilities to be eligible for FHA insurance, and hope that this language will be approved to allow Critical Access Hospitals to continue to be eligible for FHA insurance.

The efforts of FHA's Healthcare programs are essential in achieving the Department's mission of strong, sustainable, inclusive communities and quality, affordable housing and services for all Americans.

VI. Conclusion

Mr. Chairman, there are real signs of recovery in the nation's housing market. Given the progress we've seen—and FHA's central role in that progress—it's clear that FHA has fulfilled its intended role in the nation's housing finance system. It has allowed millions of American families to benefit from homeownership and affordable rental options. It has ensured much needed liquidity in the nation's mortgage finance markets. And it has acted as a vital stabilizing force when an economic crisis precipitated by the housing market could have resulted in this country's second Great Depression. Our job now is to be good stewards of taxpayer dollars and ensure FHA can continue be a source of opportunity and access to homeownership for future generations. We are committed to that goal, and we look forward to working with you to achieve it.